The students objected that there were no faculty around and were no classes, so they felt cheated in some way and asked why they had to show up at all. We replied that they didn't, since all the materials they needed were online anyway. The students were assigned mentors who were on campus, but after a while students interacted with them by instant message instead of walking down the hall even when the students were on campus. The students started out hating what we did and wound up loving it. These were students in master's degree programs and they were, in essence, simulating the jobs they were preparing for.

Even the faculty in Pittsburgh came to appreciate what we were doing in California. But you will never hear about it (except from me). Carnegie Mellon will never brag about it or publicize it in any way.

Why not?

What I did is very threatening. At one point the provost, realizing that since the program was online, in principle we could serve a lot of students, asked me whether I was going to put Golden Arches over the campus and say over a million served. Seemed a good idea to me. But not to Carnegie Mellon. We don't want to cheapen our brand name, the provost told me.

In other words, if hundreds of thousands of people had Carnegie Mellon degrees, how prestigious would such a degree be? These degrees were in computer science, a field in which Carnegie Mellon is number one or two in the world. But if too many people had these degrees, the university's prestige would go down, so whether or not this was good educational practice, and the certifying boards certainly thought it was, this was never going to happen.

I made the mistake of saying in an interview how well our experiment was going, and was told by Carnegie Mellon to stop doing that. It seemed that parents of undergraduates at Carnegie Mellon were calling and asking why, if this method was so preferable to the usual course-based method, it wasn't being employed in Pittsburgh? Since that could never happen—the professors would never allow it—I had to stop giving interviews.

As I write this, the learn-by-doing master's degree programs we built are still running, but no more will be developed at Carnegie Mellon. Eventually the ones I built will be shut down. The reason will be that they employ teachers who teach (as mentors) all the time and therefore don't do research and that can't be allowed. Not if you are in the superstar prestige game.

Universities will not change until some equally prestigious online university is developed that challenges their ability to attract students. As long as students show up at Yale, and there is no danger there in the foreseeable future, Yale does not have to change.

But Yale must understand what it is doing to the high school system. It has to stop telling the high schools what to teach. It has to stop talking about how high schools must prepare students for college. That should not be its job. Yale has to accept the idea that students will arrive at Yale "unprepared" for college. Making Yale's admissions process easier should not be the job of the high schools. Teaching the subjects that superstars don't want to teach should not be the job of the high schools. High schools need to focus on the concerns and issues of real students living in the real world. If Yale really believes in algebra for its students, then it can teach algebra to all entering freshmen. (Believe me, it never will.)

Until subjects cease to be the basis of the structure of universities, there will be a big problem in education across the planet because everyone everywhere assumes that university degrees are important. As long as we assume this, and as long as we accept that what is taught in high school will be determined by the universities, we are in serious trouble. High schools have become college preparation centers and thus no one learns anything but academic subjects in high school.

Cognitive processes must be the meat of high schools and should be the basis of college as well. The top-tier colleges will not change and maybe they shouldn't. They can continue to be research universities and specialize in producing the next generation of Nobel physicists or literary scholars. Great scientists are nice and I am all for producing them. But the 3,000 colleges in the United States are not all producing great physicists. Still they teach chemistry and require mathematics for no reason that anyone can remember.

If we don't start thinking seriously about how to teach thinking, as opposed to academic subjects, to the 99% of students who have no intention of becoming scholars, we will all lose.

CHAPTER 14

What Can We Do About It?

> Simple solutions seldom are. It takes a very unusual mind to undertake analysis of the obvious.
>
> —Alfred North Whitehead

What is obvious here? Schooling is broken. It needs to be rethought. What can we build as an alternative? It is a simple question really. If we had all the resources in the world and we really wanted to educate our children, where education means teach them to think clearly, live well-thought-out lives, and be able to pursue their dreams, what would we build?

It is, of course, very difficult to think about replacing sacred institutions. The only way I know to think about it, is as a thought experiment. Just imagine that we lived in a different world, maybe a Greek colony in the 1st century, and ask yourself how we might educate our children in this environment, pretending that schools are the one thing we cannot build for some reason. As we think about this, we must not assume that what we teach in schools now needs to be taught in some other way. We simply need to ask: *What should one teach children?* while making no assumptions that what we have been teaching is necessarily relevant.

To put this another way, the right question to ask is: *What do children need to be able to do, in order to function in the world they inhabit?* The next question is, of course, How would we teach children to do those things?

Now admittedly I am prejudicing the answer here by simply leaving out the word *know*. The usual question is, What should children *know*? It is this question that leads people to make lists of things every 3rd-grader should know and allows school boards to create lists of facts students need to be tested on. So, let's leave that word out of the discussion and see where it gets us.

A good place to start is to ask what a highly functioning adult can do and moreover has to be able to do in order to live in this world. When we ask this question, the phrase "21st-century skills" will not come up. Every time that phrase comes up, somehow the answer turns out to include algebra and calculus and science, which, the last I heard, were 19th-century skills too.

In fact, let's not talk about particular centuries at all. To see why, I want to diverge for a moment into a discussion of the maritime industry, a subject with which I have become more fascinated over the years. What did a mariner from Ancient Greece have in common with his modern counterpart in terms of abilities?

The answer is an obsession with weather, ship maintenance, leadership and organization, navigation, planning, goal prioritization, and handling of emergencies.

Effective mariners from ancient times would have in common with those of today is an understanding of how to operate their ships, the basic laws of weather, tides, navigation, and other relevant issues in the physical world, and an ability to make decisions well when circumstances are difficult. They also would have to know how to get along with fellow workers, how to manage the people who report to them, as well as basic laws of commerce and defense.

In fact, the worlds they inhabit, from an educational point of view, that is, from thinking about what to teach and how to teach it, would be nearly identical except for one thing: how to operate and maintain the equipment. Their ships were, of course, quite different.

So, let's reformulate this question that seems to haunt every modern-day pundit on education (usually politicians or newspaper people). What are 21st-century skills? Can this question be transformed (for mariners) into what does a 21st-century mariner need to be educated about that his Ancient Greek counterpart was not educated about?

The answer, it seems obvious to me, is 21st-century equipment and procedures: engines, navigation devices, particular political situations, computers, and so on. But, and this is an important "but," none of this stuff is the real issue in the education of a mariner. The real issue is decision making. What one has to make a decision about is secondary to the issue of knowing how to make a decision at all.

You can learn about a piece of equipment or a procedure by apprenticeship. Start as a helper and move on gradually to being an expert. But this is not what school emphasizes. School typically attempts to intellectualize these subjects. Experts write books about the theory of how something works and the next we know, schools are teaching that theory as a prelude to actually doing the work. Scholarship has been equated with education. You do not have to know calculus to repair an engine. You might want to know calculus to design an engine, but that is no excuse for forcing every engineer to learn it. Similarly, you do not have to know theoretical physics to master the seas. Mariners do know physics, of course—practical physics about load balancing, for example—but they do not have to know how to derive the equations that describe it.

What I am saying here about the shipping industry holds true for every other area of life as well. Twenty-first-century skills are no different from 1st-century skills. Interestingly, Petronius, a 1st-century Roman author, complained that Roman schools were teaching “young men to grow up to be idiots, because they neither see nor hear one single thing connected with the usual circumstances of everyday life.” In other words, schools have always been about educating the elite in things that don’t matter much to anyone. This is fine as long as the elite don’t have to work.

But today the elite have extrapolated from what they learned at Harvard and decided that every single schoolchild needs to know the same stuff. So, they whine and complain about math scores going down without once asking why this could possible matter. Math is not a 21st-century skill any more than it was a 1st-century skill. Algebra is nice for those who need it, and useless for those who don’t. Skill in mathematics is certainly not going to make any industrial nation more competitive with any other, no matter how many times our “experts” assert that it will. One wonders how politicians can even say this junk, but they all do.

Why?

My own guess is that, apart from the fact that they all took these subjects in school (and were probably bad at them—you don’t become a politician or a newspaper person because you were great at calculus), there is another issue: They don’t know what else to suggest.

Thinking about the 1st-century will help us figure out what the real issues are. People then and people now had to learn how to function in the world they inhabit. This means being able to communicate, get along with others, function economically and physically, and in general reason about issues that confront them. It didn’t mean then, and doesn’t mean now, science and mathematics, at least not for 95% of the population.

How do we choose who studies the elite subjects? We don't.

Offer choices. Stop making lists of what one must know and start putting students into situations where they can learn from experience while attempting to accomplish goals that they set out for themselves, just as people did before there were schools. Education has always been the same: learning from experience with help from wiser mentors. School has screwed that all up and it is time to go back to basics.

So the "what" question is simple. We should teach children what adults know that enables them to function in the world they inhabit. This has much less to do with academic knowledge than it has to do with practical, and often subconscious, knowledge of how to do a variety of things in the social and physical and economic world we have created.

Now let's address the question of how to teach these things.

John Dewey noted, in 1916, that he had been talking about learning by doing for a long time, but nobody ever listened to him about it—which was exactly his point. He was frustrated about changing the system. In 1916! Imagine how he would feel today.

It is not unreasonable to ask why the system never changes, and who is making sure that it won't change. The answer is obvious. So many people have vested interests in things staying as they are that the system basically cannot change—at least not of its own free will.

The President of the United States could help make the changes needed, but he won't. Here is a piece from then-Senator Obama's education speech given during his campaign in Dayton, Ohio, in 2008:

> We will help schools integrate technology into their curriculum so we can make sure public school students are fluent in the digital language of the 21st-century economy. We'll teach our students not only math and science, but teamwork and critical thinking and communication skills, because that's how we'll make sure they're prepared for today's workplace.

Some advisor of his had read my writings and was quoting me on that one. I usually say reasoning and not critical thinking, but this is taken from my many speeches on education. And what has the President actually done? He said in that same speech:

> And don't tell us that the only way to teach a child is to spend most of the year preparing him to fill in a few bubbles on a standardized test. I don't want teachers to be teaching to the test. I don't want them uninspired and I don't want our students uninspired.

Uh huh. Did he change No Child Left Behind? No. Of course not. Testing dominates education as much as it ever did. All presidents are the same, really. They can't fight the vested interests, or won't. I will avoid figuring out why here, although, once again, John Dewey had much to say on the subject of how governments stay in power by making sure that people aren't really educated.

We can't count on politicians, but here is what we can do. We can build it and then we can work inside or outside the system in such a way that allows people to be able to come.

But how do you build a new high school system? Very simple: one curriculum at a time. The trick is making sure that you put the curricula online. We cannot change education one school at a time. Many good schools have been created over the years. Today, John Dewey's Lab School (in Chicago), which was entirely a learning-by-doing place, is now a college prep school. Having a few reasonable schools will not change the system. A curriculum offered online is available to everyone and eventually can provide an alternative to a system that offers boring and mindless education.

In addition, *online* means *choices*. Once we create dozens, maybe hundreds, of curricula from which to choose, students should be able to learn anything they want to learn without regard to whether a teacher for that curriculum or other students interested in that curriculum happen to live nearby.

So, in an ideal world, what would these curricula be about?

They can be about anything that one can learn to do in the real world (which would leave out all the traditional academic subjects). They should teach teaching cognitive processes, of course, but one should not endeavor to teach cognitive processes specifically, that is, apart from their possible use. So, it is the use of these processes in some area of real life that would be the intent of any full-year, story-centered curriculum.

These curricula and any others that we would design have the following characteristics:

1. They must be learn-by-doing curricula consisting of series of projects inside coherent stories about life in some aspect of the real world.
2. They must be delivered on the web. Students should work on projects where the background and help are web delivered. They would submit their work to mentors and receive feedback online.
3. Mentors in the curricula would include parents, online subject matter experts worldwide, local experts, and teachers trained to be mentors. Mentoring, unlike teaching, is not about providing information that can be found easily in books but about helping students through a problem without giving them the answer. Mentors point students in the right direction and react to their work as it progresses.
4. Students should, on a regular basis (sometimes weekly, sometimes more often), submit work products related to each project for evaluation and feedback. Students would submit their work many times to achieve increasing mastery and get continuing feedback. There should be no competency tests, only the continual monitoring of performance.
5. Each curriculum should be designed by a panel of experts in a given field. The curriculum should provide a simulation of what life might be like in that field. For example, students might spend the year working legal cases, or starting a business, or designing roads and bridges.
6. Students should be encouraged to work in virtual teams, learning to deal with others to produce results.
7. Choice must be a staple of the curricula. There can be no single set of standard requirements. Instead, students should be able to select the curricula they wish to participate in. Their records would list what deliverables they have created in their chosen curricula.
8. Curricula must be designed around projects with clear, meaningful, achievable goals. They must be designed carefully so to incorporate all the key basic skills like reading, writing, reasoning, researching, calculating, computing, and so on, in a systematic and natural way.

Here are some curricula that have been proposed that would meet student's interests head on, that would be able to teach them to be good at a variety of skills (including all 12 cognitive processes), and that would make the students employable as well:

- Criminal Justice
- Sports Management
- The Music Business
- The Legal Office
- Military Readiness
- The Fashion Business
- Aerospace Engineering
- Computer Networking
- Homeland Security
- Medical Technology
- Construction
- Computer Programming
- Television Production
- Real Estate Management
- Architecture
- The Banking Industry
- Automotive Engineering
- Architecture
- Biotechnology
- Film Making
- Travel Planning
- Financial Management
- Parenting and Childcare
- Starting an Online Business
- Urban Planning
- Hotel Management
- Health Sciences
- The Food Industry
- Graphic Arts
- Communication
- Veterinary Science
- Marketing
- Telecommunications
- Scientific Reasoning

Obviously, this list could be much longer. The intention here is to make any student excited about learning because what he or she wants to learn about is offered. The trick for the designers of the curricula is to make sure that students' interest is grabbed and maintained for a full year, while teaching them how to hone their capabilities at the 12 cognitive processes.

What are the obstacles?

What would prevent this from happening? Really there are only four issues:

Finding people who know how to build the curricula
Paying the people who will build the curricula
Convincing schools or other entities to offer the curricula
Training teachers to be mentors in these curricula

Smart, articulate, people who are well organized and can write well can easily learn to do the bulk of the work involved in building a course as long as they have access to experts and are guided by experienced designers, and the project is run by someone how knows how to run projects. Finding people who can do this work is not a problem. Being able to pay them for the year or so that it takes to do the work is the real issue.

This leads us to discuss who would pay for this. The answer should be the federal government, but it is clear that that will never happen. The federal government, as any interested citizen knows, is influenced mightily by big business, especially when big business has profits to protect.

Companies that produce textbooks and companies that produce and grade exams will not stand by and see their revenues drop. Any alternative curriculum that did not use textbooks and did not use standardized tests would be anathema to them. Companies that have billions of dollars in revenues from textbooks know how to encourage politicians to protect their interests.

What about the testing industry? A recent report says that "the testing industry is somewhat secretive." I wonder why. But sometimes they do report revenue. To give an example, the revenue of Kaplan Inc., which is just one of many test preparation companies, was over $1 billion in 2008. Who owns Kaplan? *The Washington Post.* So while the testing companies make great profits, the nation's newspapers, having a vested interest in those profits, tout testing as the country's salvation. The most visible touter is the Secretary of Education, who gives eloquent speeches about more rigorous testing that are, of course, printed in *The Washington Post.*

Why would President Obama want to do the same thing as President Bush did, especially when he campaigned against No Child Left Behind, as I pointed out earlier? The answer is simple. There is lots of money invested in testing by powerful players. Kids are no one's main concern.

So the money for the new plan will not be coming from the government.

What about from business? Venture capital, for example?

Is a new kind of high school offered online likely to be a successful business venture? One mentor in the story-centered curriculum can handle between 20 and 50 students, depending on the mentor's experience. Assuming that the students pay tuition that covers the mentor's salary, which means they need to pay at least $3,000 a year, more or less, in tuition, it shouldn't cost anything to run. Charge larger tuitions and there will be profits. Initial investment is about $2 million to build a curriculum, but enough students paying reasonable tuitions will pay that investment back quickly enough. So, is this a big business opportunity?

Actually I doubt it. I think that it is a big opportunity for universities that traditionally charge large tuitions. We have had a great deal of success with master's degrees, for example. But universities typically don't invest $2 million in anything, even if it does have great upside potential. When Carnegie Mellon University made that investment in its West Coast campus (where I was designing the curriculum), it did so without quite knowing it was doing so because the person in charge didn't tell the University officials what he was up to. Universities typically don't think about investing money in order to make money in the daily enterprise. Businesses do think that way, of course, but businesses have trouble starting universities that are accredited. I worked for Trump University, which supposedly was going to do exactly that, but they never could raise enough money or figure out how to be accredited. So there is a potentially very big business in master's degrees, but it needs some well-financed and prescient people to make it happen.

High schools are another story. I actually do not believe that business will invest in online high schools whose mission is to overthrow the existing system. Venture capitalists are not revolutionaries. They tend to follow the herd in whatever they do and there is no herd in education except the one promoting more testing. They certainly do invest in that.

So we are left with appealing to people who actually care about kids and their education. Money isn't and shouldn't be the allure here. This means that the saviors of education will have to be wealthy individuals or foundations started by wealthy individuals.

The health sciences curriculum that we built was funded by the Ewing Kauffman Foundation. We built it using our not-for-profit company, Engines for Education. I really believe that no alternative to the nonprofit model funded by wealthy people exists. We just have to find people who care about education. They are in short supply, and they typically aren't the wealthy people who make pronouncements about education, but I am hopeful that they are out there.

I wouldn't mind being wrong about anything I have said here. The federal government could get taken over by people who actually care about kids and not votes.

How do we convince schools to offer these curricula once they have been developed? It won't be easy. There aren't that many schools run by people who realize that the system is broken. But they do exist, however. The real problem is not so much convincing the head of a private school or the superintendent of a school district. It is more about convincing parents who fundamentally do not understand education, or teachers who have taught what they have always taught and really don't want to learn new skills.

And, in addition, there are all those state standards. The first thing that any school that wants to use our curriculum has to do is to see how they can map what we will teach into their state's standards. If the state standards specify 2 years of algebra, we are out of luck. If they have vague science standards, we are in better shape. Either way, the state standards, passed by all those brilliant state legislatures that know all there is to know about what should be taught in high school, inhibit real change in the system.

So we need motivated heads of schools or school systems, in states that have flexible standards, where parents who hold views about why school was better in their day do not have to be listened to. Do these exist?

Sure.

The last issue is training teachers to mentor. We do this by having teachers be students in a curriculum mentored by others who have experience in that curriculum. Mentoring does not come naturally to people who have been teaching in the usual way. But they pick it up and often find that they like it better.

Here is Lynn Carter, one of the first mentors we trained to teach in this new way at CMU's West Coast campus. He is a professor of software engineering at Carnegie Mellon University.

> It has taken me a while to figure out how to undo about 25 years of teaching experience that was standing in front of a room and talking, but I really like it. I enjoy interacting with students. As much as I enjoy standing in front of students and talking, it is much more satisfying to be dealing with smaller groups, more of a one-on-one interaction.
>
> Professors often complain that no students come to see them during their office hours. That isn't a problem with us here.

How did we teach Professor Carter to mentor Socratically? It wasn't trivial to do, but it didn't take that long either. Once a teacher gets the idea that his job is not telling but helping, he gets into the swing of it fairly easily. Training teachers to teach in the kinds of SCCs we propose for high school is more an issue of familiarizing them with the content, which will differ considerably from what they have been teaching. Handholding comes naturally to most people because they have been doing that kind of teaching all their lives with siblings and children. Lecturing is not a natural human activity and teachers are easily dissuaded from doing it as long as they are not being presented with a classroom of listeners.

In the end, the real question is this: Why do we still have schools?

This is a little like asking why we still have religious institutions. In fact, it is a lot like asking that question because you will get the same reactions. People get used to the institutions that have always been a part of their lives. The fact is that these institutions were created in a different time when knowledge was harder to come by and the economy was quite different.

Religion is not my issue. Should we still have schools?

Instead of answering this question by listing all the good things that schools provide—no one would argue that a literate population is a bad thing, for example—I will turn the question around: What is bad about having schools?

Here is a list of what is bad. Following the list, I will explain what is bad about these things (assuming it isn't obvious).

Schools emphasize competition.
Schools make kids stressed.
Schools know the right answers.
Schools enable bullying and peer pressure.
Schools stifle curiosity.
Schools choose the subjects for students.
Schools have classrooms.
Schools give grades.
Schools provide certification.
Schools confine children.
Schools claim that academics are the winners.
Schools do not value practical skills.
Schools cause students to want to please teachers.
Schools cause students to question their self-worth.
Schools are run by politicians.
Governments use education for repression.
Discovery is not valued in school.
Boredom is seen as a bad thing in school.

Competition: Why should school be a competitive event? Why do we ask how a kid is doing in school? Learning in life outside of school is not a competitive event. We learn what we choose to know in real life.

Stress: When 6-year-olds are stressed about going to school, you know that something is wrong. Is learning in real life stressful? Stress can't be helping kids learn. What kid wouldn't happily skip school on any given day? What does this tell us about the experience?

Right answers: School teaches that there are right answers. The teacher knows them. The test makers know them. Now you have to know them. But in real life, there are very few right answers. Life isn't mathematics. Thinking about how to behave in a situation, planning your day or your life, plotting a strategy for your company or your country—no right answers.

Bullying and peer pressure: You wouldn't have to have *say no to drugs or cigarettes* campaigns if kids didn't go to school. In school there are always other kids telling you how to dress, how to act, how to be cool. Why do we want kids' peer groups to be the true teachers of children? Being left out terrorizes children. Why do we allow this to happen by creating places that foster this behavior?

Stifling of curiosity: Isn't it obvious that learning is really about curiosity? Adults learn about things they want to learn about. Before the age of 6, prior to school, one kid becomes a dinosaur specialist, while another knows all about dog breeds. Outside of school, people drive their own learning. Schools eliminate this natural behavior.

Subjects chosen for you: Why algebra, physics, economics, and U.S. history? Because those subjects were pretty exciting to the president of Harvard in 1892. And, if you are interested in something else—psychology, business, medicine, computers, design? Too bad. Those subjects weren't taught at Harvard in 1892. Is that nuts or what?

Classrooms: If you wanted to learn something and had the money, wouldn't you hire someone to be your mentor, and have them be there for you while you tried out learning the new thing? Isn't that what small children have, a parent ready to teach as needed. Classrooms make no sense as a venue for learning unless, of course, you want to save money and have 30 (or, worse, hundreds of) students handled by one teacher. Once you have ratios like that, you have to teach by talking and then hoping someone was listening, so then you have to have tests. Schools cannot work as places of learning if they employ classrooms. And, of course, they pretty much all do.

Grades: Any professor can tell you that students are pretty much concerned with whether what you are telling them will be on the test and what they might do for extra credit. In other words, they want a good grade. If you tell them that 2 + 2 = 5 and it will be on the test, they will tell you that 2 + 2 = 5 if it means getting a good grade. Parents do not give grades to children and employers do not give grades to employees. They judge their work and progress for sure, but not by assigning numbers to a report card.

Certification: We all know why people attend college. They do so primarily to say they are college graduates so they can get a job or go on to a professional school. Most don't care all that much about what hoops they have to go through. They do what they are told. Similarly, students try to get through high school so they can go on to college. As long as students are not in school to get an education, you can be pretty sure they won't get one. Most of our graduates have learned to jump through hoops, nothing more.

Confined children: Children like to run around. Is this news to anyone? They have a difficult time sitting still and they learn by trying things out and asking questions. Of course, in school sitting still is the norm. So we have come up with this wonderful idea of ADHD, that is, drug those who won't sit still into submission. Is the system sick or what?

Academics viewed as winners: Who are the smartest kids in school? The ones who are good at math and science, of course. Why do we think that? Who knows? We just do. Those who are good at these subjects go on to be professors. So those are certainly the smartest people we have in our society. Perhaps they are. But I can tell you from personal experience that our society doesn't respect professors all that much, so something is wrong here.

Practical skills not valued: When I was young, there were academic high schools and trade high schools. Trade high schools were for dumb kids. Academic high schools were for smart kids. We all thought this made sense. Except that are a lot of unemployed English majors and a lot of employed airplane mechanics. Where did we get the idea that education was about scholarship? This is not what Ben Franklin thought when our system was being designed, but he was outvoted.

The need to please teachers: People who succeed at school are invariably people who are good at figuring out what the teacher wants and giving it to her. In real life there is no teacher to please and these "grade grubbers" often find themselves lost. When I did graduate admissions, if a student presented an undergraduate record with all A's, I immediately rejected him. There was no way he was equally good at or equally interested in everything (except pleasing the teacher). As a professor, I had no patience for students who thought that telling me what I just told them was the essence of academic achievement.

Self-worth questioned: School is full of winners and losers. I graduated number 322 in my high school class (out of 678). Notice that I remember this. Do you think this was good for my self-esteem? Even the guy who graduated number 2 felt like a loser. In school, most everyone sees themselves as a loser. Why do we allow this to happen?

Politicians in charge: Politicians demand reform but they wouldn't know reform if it hit them over the head. What they mean is that school should be like they remember rather than how it is now, and they will work hard to get you to vote for them to give them money to restore the system to the awful state it always was in. Politicians, no matter what party, actually have no interest in education at all. An educated electorate makes campaigning much harder.

Government use of education for repression: As long as there have been governments, there have been governments that wanted people to think that the government (and the country) is very good. We all recognize this tendency in dictatorships that promote the marvels of the dictator and rewrite history whenever it is convenient. When you point out that our government does the same thing, you are roundly booed. We all know that the Indians were savages that Abraham Lincoln was a great president and that we are the freest country on earth. School is about teaching "truth."

Discovery not valued: The most important things we learn we teach ourselves. This is why kids have trouble learning from their parents' experience. They need their own experiences to ponder and to learn from. We need to try things out and see how they go. This kind of learning is not valued in school because it might lead to, heaven forbid, failure, and failure is a really bad word in school. Except failure is how we learn, which is pretty much why school doesn't work.

Boredom ignored: Boredom is a bad thing. We drug bored kids with Ritalin so they will stop being bored. All of my best work has come when I was most bored and let my mind wander. It is odd that we keep trying to prevent this from happening with kids. Lots of TV, that's the ticket.

Major learning by-doing mechanism ignored: And last but not least, scholars from Plato to Dewey have pointed that people learn by doing. That is how we learn. Doing. Got it? Apparently not. Very little doing in schools. Unless you count filling in circles with number 2 pencils as doing.

Online education can change all this. Build it right once and children the world over will have the opportunity to learn how to think and to learn how to work. Such a system would be capable of changing fast. Any new industry or market or technology could produce a course in what is needed to work in that field and instantly get the people it needed.

Schools are an ancient artifact that can't last much longer.

Notes

Chapter 1

1. In the United States it all stems from a meeting of the Committee of Ten chaired by the president of Harvard in 1892.

2. John Adams, the second president of the United States, said that school should teach us how to live and teach us how to make a living. No subsequent U.S. president has ever understood this point, however.

Chapter 2

1. Paul Ramsden. *Learning to Teach in Higher Education*. New York: Routledge, 1992..

2. Arthur W. Chickering and Zelda F. Gamson. "Seven Principles for Good Practice in Undergraduate Education." *The American Association for Higher Education Bulletin,* March 1987.

3. John V. Adams, Student Evaluations: The Ratings Game. *Inquiry, 1*(2), Fall 1997, 10–16.

Chapter 3

1. From a column by Robert Jamieson, Jr., Seattle PI.com, February 27, 2008.

2. I didn't start writing about education until 1978. Before that it was always artificial intelligence that concerned me.

3. I have done this in gory detail in *Dynamic Memory* and in *Dynamic Memory Revisited* as well as in *Explanation Patterns*.

4. *Tell Me a Story*.

Chapter 5

1. For more on the origins of the school system, see *The Origins of the American High School* as well as *Making Minds Less Well Educated Than Our Own*.

2. Socratic Arts, a company that builds learning-by-doing software for schools, businesses, and government.

Chapter 7

1. Report Urges Changes in Teaching Math , *New York Times,* March 14, 2008.
2. Daniel Willingham, *Why Don't Students Like School: A Cognitive Scientist Answers Questions About How the Mind Works and What It Means for the Classroom.* San Francisco: Jossey Bass, 2010

Chapter 8

1. *Scripts, Plans, Goals and Understanding* (1977) and *Dynamic Memory* (1981).

Chapter 9

1. I wrote about this in some detail in *The Future of Decision Making* and have been building this kind of thing for big corporations.
2. There are many experiences one could build. I talked about some that we have built for high school and graduate school in Chapter 8. At the end of this chapter, I talk about one for little kids.
3. *Scripts, Plans, Goals, and Understanding.*
4. For example, *Dynamic Memory* and *Inside CBR.*
5. Richard Neustadt and Ernest May, *Thinking in Time: The Uses of History For Decision Makers,* Washington, D.C.: Free Press, 1988
6. Taken from *Smart Parenting,* Brad Smart and Kate Smart .Mursau: CDK Press, 2007.
7. Roger Fisher, author of *Getting to Yes.*
8. Blaise Pascal usually gets the credit.

About the Author

Roger Schank is the CEO of Socratic Arts and Managing Director of Engines for Education. He was Chief Education Officer of Carnegie Mellon West, Distinguished Career Professor in the School of Computer Science at Carnegie Mellon University, and Chief Learning Officer of Trump University. He founded the renowned Institute for the Learning Sciences at Northwestern University, where he is John P. Evans Professor Emeritus in Computer Science, Education, and Psychology. He has taught at Yale University, the University of Paris VII, and Stanford University. He holds a Ph.D. in linguistics from the University of Texas. He is a fellow of the AAAI and was founder of the Cognitive Science Society and co-founder of the *Journal of Cognitive Science.* He is the author of more than 25 books on learning, language, artificial intelligence, education, memory, reading, e-learning, and storytelling. Recently he has been consulting with businesses about how to be more innovative, and how to manage their corporate knowledge so that it is delivered just in time.

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Active Escapes, Quiet Getaways and More

Wednesday, July 27, 2011

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Some people do yoga on vacation; others go for the occasional run. This week we're thinking a little more... adventurously, from active escapes at Travaasa Hana in Maui to racecar driving in Baja and hiking Moab with the experts at Austin-Lehman Adventures. And after all that action, chill out with stays at the new Dream South Beach, the gorgeous Pavilions Phuket and other luxe resorts worldwide. (Image: The Pavilions Phuket - on sale Fri, July 31.)

Sales this week

Starting Tuesday at Noon BST
Dream South Beach
Travaasa Hana - Hawaii
Esencia Estate - Riviera Maya

Starting Tuesday at 8pm BST
AVIA Hotel - Long Beach, CA
Hotel Las Palmas - Mexico

Starting Wednesday at Noon BST
Last-Minute London and NYC

Starting Wednesday at 8pm BST

Starting Thursday at Noon BST

Starting Thursday at 8pm BST

Fairmont Turnberry Isle Resort

Sofitel - Philadelphia

Hotel Derek - Houston
Arches to Moab
Spirit Ridge, British Columbia

Starting Friday at Noon BST
Hotel Allegro - Chicago

Starting Friday at 8pm BST
Vidago Palace - Portugal
The Manor On Golden Pond - NH
Candia Maris Resort - Crete

Starting Saturday at Noon BST
Round Hill - Jamaica
Fairmont Royal Pavilion
Experience Baja, Two Ways
Maca Bana - Grenada

Starting Sunday at Noon BST
Alila Sothea - Cambodia

Starting Sunday at 8pm BST
The Pavilions - Phuket
Siam Kempinski Hotel Bangkok
Anantara Bophut - Koh Samui

Starting Monday at 8pm BST
The Madison - D.C.
Grand Hyatt Atlanta
Hotel Bellevue - Washington
The Adolphus - Dallas

Art Deco Meets Modern at South Beach Newcomer

Dream South Beach

This South Beach newcomer lives up to the hype. Set in two landmark Art Deco buildings on Collins Avenue, right behind the former Versace Mansion, the boutique hotel has 108 sleek guestrooms washed in blue and white, and access to soft, sandy beaches, a restaurant helmed by chef Geoffrey Zakarian and a hip rooftop pool scene.

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Maui's Memorable Journey

Travaasa Hana - Hawaii

Reinvented from the former Hotel Hana Maui, the brand new Travaasa Hana combines - in concept and name - travel and pravaasa ("memorable journey" in Sanskrit). The mix of adventure, relaxation and truly experiencing a destination are hallmarks of Travaasa. With the beauty of Hana, Hawaii, all around, it's hard to imagine a better marriage of purpose and place.

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The Royal Ferrari Hideaway

Esencia Estate - Riviera Maya

It's rare to find a luxury resort as down to earth as this *Condé Nast Traveler* Hot List alum. Sitting on 50 wild acres of jungle by the beach, this striking Italian-style villa has white sand-colored interiors that match the serene beach outside. The Duchess of Ferrari originally built this tropical hideaway on Mexico's fabled Yucatan Peninsula in the early 1990s to entertain her globetrotting friends. It has since been remade as a 29-room boutique wonder, where that local culture is so intrinsic to the design that it can be found in the minutest details.

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A Barefoot Hideaway in Zihuatanejo

Hotel Las Palmas - Mexico

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On a nine-mile stretch of Playa Blanca, just 20 minutes from downtown Zihuatanejo, Hotel Las Palmas is unique escape between lush rain forest and the open Pacific Ocean. All 10 suites were individually designed by Enrique Zozaya in a sleek, modern-tropical style and capture the unspoiled views on private terraces and balconies. With the soaring Sierra Madre del Sur mountains in the distance and sleepy fishing village of Barra de Potosi close by, the Hotel Las Palmas is a true barefoot hideaway in a quintessentially Mexican setting.

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Minimalism to the Max in Long Beach

AVIA Hotel - Long Beach, CA

There's a lot to love in Long Beach. It's the sixth largest city in California (with nearly half a million people), one half of the western hemisphere's largest port, and it's finally coming into its own as a magnet for travelers. The modern, 138-room AVIA Hotel sits at the epicenter of all the action. And the cheery Long Beach lovers staffing the property are happy to highlight the best of the city.

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Last-Minute London and New York City

It's hard to imagine, but true: Summer will slip away before you know it. Which means it's time for a mini-getaway to one of your favorite cities. And this is the time to go - the streets are quieter, the parks are in bloom and concerts, movies and performances are staged nearly every day. We've got last-minute availability at the Landmark London and three Manhattan standouts: the elegant Hôtel Plaza Athénée, the family-friendly Roger Williams and the über-sleek Thompson LES. Choosing can be tough when the options are so good.

Hôtel Plaza Athénée

Starting Wednesday 27/7 at 5pm BST

The Landmark London

Starting Wednesday 27/7 at 5pm BST

Thompson LES

Starting Wednesday 27/7 at 5pm BST

Hotel Roger Williams

Starting Wednesday 27/7 at 5pm BST

Mediterranean Style in South Florida

Fairmont Turnberry Isle Resort

Located 20 minutes north of Miami Beach in the heart of Aventura, Fairmont Turnberry Isle Resort & Club mixes country club charm with the sleek styling of a boutique hotel. The 392-room property is home to two Raymond Floyd-designed golf courses and the Laguna Pool, which features a water slide, a lazy river and cabanas outfitted with TVs and refrigerators (this is Miami, after all). With its family-friendly vibe, Turnberry Isle falls somewhere between Grossinger's in the Catskills (at its legendary height) and a posh island resort.

Click here to preview sale

Starting Wednesday 27/7 at 8pm BST

French Service Meets American History

Sofitel - Philadelphia

In the city's former stock exchange building, the 306-room Sofitel is retrofitted with streamlined rooms and an intimate brasserie. This Philadelphia gem is where French and American style come together - think Shaker quilts next to spacious marble bathrooms - in the French Quarter of an All-American destination.

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Starting Thursday 28/7 at Noon BST

Adventures in Utah with Austin-Lehman

Arches to Moab

Epic renderings of sandstone and the frothy beauty of the Colorado River form the backdrop for Austin-Lehman's six-day exploration of the Utah desert in and around its fabled adventure capital, Moab. Guests hop on bicycles, bound down the river in rafts, clamber into 4x4s, and, of course, hike into some of the most jaw-dropping geology on the planet. Evenings are as relaxing as the days are active, with a fixed homebase - a lodge set against red-rock cliffs that happens to have its own winery.

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Starting Thursday 28/7 at 8pm BST

Wine and Golf in the Napa of the North

Spirit Ridge, British Columbia

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Known as Napa of the North, Canada's Okanagan region is a year-round retreat east of Vancouver. The area is home to award-winning wineries, Canada's warmest lake and a stunning desert landscape fit for golfing virtually every day of the year. With exceptional service and Pueblo-style architecture, Spirit Ridge Vineyard Resort & Spa is just as much a hotel for oenophiles looking to unwind as it is for golf fanatics and families looking to take advantage of mild weather and myriad activities.

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Starting Thursday 28/7 at 8pm BST

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Houston's Worldly Side

Hotel Derek - Houston

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Near swank shops and Houston's art-gallery scene, the Hotel Derek is designed to feel like a superhip home, with 60s-style settees, English wingback chairs and cowhide rugs. The hotel works on the assumption that its guests have the same qualities as the fictional host, Derek: worldliness, a sense of humor and an eye for beauty.

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Starting Thursday 28/7 at 8pm BST

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Chicago Shows its Quirky Side

Hotel Allegro - Chicago

It starts with a grand entrance: You'll walk in on a three-story staircase as wide as an IMAX screen. A double-sided fireplace and baby grand piano jazz up the lobby while Technicolor furnishings like cherry-red sofas and silver wallpaper add to the whimsical vibe. The Allegro, a Kimpton hotel, is a vibrant example of boutique-style hospitality in Chicago that playfully tips its hat to old-world glamour without ever taking itself too seriously.

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Starting Friday 29/7 at Noon BST

Sleep in a Palace in Portugal

Vidago Palace - Portugal

In the mountainous north of the country, just over an hour from Porto, the recently opened Vidago Palace has, in one fell swoop, raised the bar for luxury getaways in Portugal. As far removed from the sun and sand of the touristy Algarve as you can get, this is a destination for the discerning traveler and the lover of fine things, whether they be cigars, hand-painted silk wallpaper, the country's best spa or a championship golf course.

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Starting Friday 29/7 at 8pm BST

Beach, Spa, Repeat in Crete

Candia Maris Resort - Crete

With 285 rooms, Crete's Candia Maris beachfront resort is large by Greek hotel standards. It shares the space between the large and airy guestrooms, a choice of restaurants and a host of activities, whatever your interest. Waterbabies will love the seven pools and sybarites can camp out in the resort's Thalassotherapy spa. Overlooking Amoudara beach just outside Heraklion, the resort underwent a top-to-bottom renovation five years ago, adding modern style and amenities to this uber-resort.

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Starting Friday 29/7 at 8pm BST

The Real "On Golden Pond"

The Manor On Golden Pond - NH

Katharine Hepburn and Henry Fonda made this elegant B&B famous in the 1981 film *On Golden Pond*, but three decades later the 13-acre estate on Squam Lake remains a revered and romantic New Hampshire countryside escape. With unbeatable views of the White Mountains, Manor on Golden Pond has distinctive guestrooms - from the Cotswold Cottage to the Canterbury Manor - plus all the trappings of a sophisticated inn, with the English heritage to back it up.

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Starting Friday 29/7 at 8pm BST

An Eco Retreat on the Spice Isle

Maca Bana - Grenada

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Grenada is known as the most gregarious of the Caribbean islands, and Maca Bana, on a secluded cove on the Point Salines peninsula, represents a microcosm of that, from the general manager to the gardener. The boutique villa hotel (appropriately named after a tree in the indigenous Arawak language) has an infinity pool and beachside restaurant to entertain, plus each villa has a deck with a private hot tub. And even though the resort is just five minutes from the airport, it feels worlds away.

Click here to preview sale

Starting Saturday 30/7 at Noon BST

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High Style in Montego Bay

Round Hill - Jamaica

With room decor by Ralph Lauren, Round Hill is a true standout among the properties along the northwest coast of Jamaica. High-end yet relaxed, it has sprawling grounds and a full-service attitude that invites total indulgence for guests. It's also got awe-inspiring views of the Caribbean from the rooms, restaurants and infinity pool, where visitors feel as if they're literally floating in the sea.

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Starting Saturday 30/7 at Noon BST

A Barbados Stay Fit for Royals

Fairmont Royal Pavilion

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Skilled in the art of seduction, the Fairmont Royal Pavilion was one of the first great beach hotels to open on Barbados. Refreshed by a major 2010 renovation, this graceful Colonial-style estate makes the most of its location - by day guests swim, sail and cavort along the powdery beach or simply enjoy the views from a private terrace overlooking the water. And by night, one of the island's most elegant tables will be available, where dinner is served with the serenading sounds of the surf.

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Starting Saturday 30/7 at Noon BST

Racecars & Relaxation with Momentum Adventure

Experience Baja, Two Ways

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This six-day journey with Momentum Adventure explores the wild, stark landscape of the Baja Peninsula, and balances adrenaline-infused outings with relaxation at the iconic One&Only Palmilla. Navigate a Baja Challenger racecar through sand washes, cactus forests and lone beaches; score a hole-in-one at a Jack Nicklaus-designed golf course; and fish for blue marlins in a yacht off the shore. Come evening, sip tequila in a breezy villa that overlooks the Sea of Cortez.

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Starting Saturday 30/7 at Noon BST

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Romance Near the Temples of Angkor Wat

Alila Sothea - Cambodia

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Over the last decade, Siem Reap, the gateway to Cambodia's magnificent temples of Angkor Wat, has morphed from a dusty backpacker hangout to a picturesque town filled with an array of five-star hotels, artsy boutiques and restaurants oozing with ambience. Service here is some of the finest and friendliest in the region, a trait nowhere more evident than at the all-suite Alila Sothea. The hotel's regal 39 rooms, which surround a glittering slate-and-gold-leaf-tiled pool, offer a tranquil, resort-like atmosphere that's rich with local culture and just 20 minutes by car from Angkor.

Click here to preview sale

Starting Sunday 31/7 at Noon BST

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Hilltop Romance on Phuket

The Pavilions - Phuket

These hilltop retreats are some of Phuket's most romantic crash pads thanks to sublime panoramic Andaman Sea views and the island's most discreet staff. All villas include swimmable pools and roomy decks for sun and shade. The 360 bar attracts the island's best dressed inhabitants who flock here at sundown for the calm view then stay sipping colorful cocktails late into the warm night.

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Starting Sunday 31/7 at 8pm BST

From Cooking to Kickboxing on Koh Samui

Anantara Bophut - Koh Samui

The best part of staying at the Anantara Bophut - besides the fact that it's on a beautiful Koh Samui beach - is the activities menu, which keeps every type of traveler entertained. Spend mornings windsurfing or learning Thai kickboxing, and afternoons cooking authentic regional dishes or snorkeling in the Gulf of Thailand. If you're craving some slothful downtime, relax next to the giant lagoon-style infinity pool or in the blissful spa.

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Starting Sunday 31/7 at 8pm BST

Art Deco Meets Thai Flair in Sizzling Bangkok

Siam Kempinski Hotel Bangkok

Though it's just steps from Bangkok's best shopping malls (and the city's notorious traffic-thronged streets), the Siam Kempinski Hotel Bangkok manages to provide a tranquil getaway that feels miles from the city's chaos. Capitalizing on the hotel brand's European roots, the design is an artful blend of Art Deco accents and Thai flourishes. In 303 rooms, huge beds, baths and work/lounge areas provide ample space to recharge, while the amenities - a pool area, a spa and one of the city's best restaurants - offer plenty of excuses to stay close to home.

Click here to preview sale

Starting Sunday 31/7 at 8pm BST

Stately Style in the Heart of Washington D.C.

The Madison - D.C.

Named for James Madison, the fourth president and "father of the Constitution," this stately hotel has traditional style and refined service to match - plus, a location that puts many of Washington's must-see museums and monuments along the National Mall within walking distance. Opened in 1963, the 353-room hotel has hosted the Dalai Lama, the occasional celebrity and every U.S. president since John F. Kennedy except Barack Obama. Not to worry - you can stop by the White House, just five blocks away.

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Starting Monday
1/8 at 8pm BST

Atlanta's Tranquil Retreat, Newly Updated

Grand Hyatt Atlanta

With 438 newly renovated cream-and-beige rooms (thoughtful details include iPod docks and air purifiers), a quiet and plush restaurant that serves locally-inspired Southern dishes and a beautifully manicured 9,000-square-foot Japanese garden, the Grand Hyatt Atlanta makes a tranquil retreat in the heart of the city's Buckhead District. This is the shopping mecca of the South, so boutiques, plus lots of award-winning restaurants, are all just steps away.

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Starting Monday 1/8 at 8pm BST

The Beer Baron's Classic Dallas

The Adolphus - Dallas

Built by beer baron Adolphus Busch in 1912 two blocks from Neiman Marcus's flagship store, Dallas's Adolphus Hotel has kept its place as a favorite among distinguished visitors for years. The draw? An Old World aesthetic with traditional furniture and paintings, a hyperattentive staff and an outstanding French restaurant - right in the middle of downtown.

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Starting Monday 1/8 at 8pm BST

Beautiful Views in Washington State

Hotel Bellevue - Washington

While Seattle may be one of the smartest cities in the country, its next door neighbor Bellevue is one of the most glamorous. Appealing to both savvy business travelers and couples seeking a romantic respite, Hotel Bellevue is an unassuming retreat in an environment where wealthy residents reign supreme. The property is intimate in size (just 67 rooms), but features luxury amenities in a serene garden setting, just a few blocks from the hustle and bustle of downtown Bellevue.

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Starting Monday 1/8 at 8pm BST

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APRIL, 2014

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THE FUND AND ITS GENERAL PARTNER ARE NEWLY FORMED ENTITIES. THERE IS NO PUBLIC MARKET FOR THE INTERESTS, AND NO SUCH MARKET IS EXPECTED TO DEVELOP. EACH PURCHASER WILL BE REQUIRED TO REPRESENT, AMONG OTHER THINGS, THAT IT IS AN "ACCREDITED INVESTOR" WITHIN THE MEANING OF REGULATION D OF THE SECURITIES ACT AND THAT IT IS ACQUIRING THE INTERESTS PURCHASED BY IT FOR INVESTMENT AND NOT WITH A VIEW FOR RESALE OR DISTRIBUTION. THE INTERESTS ARE SUBJECT TO RESTRICTIONS ON TRANSFERABILITY AND RESALE AND MAY NOT BE RESOLD OR TRANSFERRED EXCEPT AS PERMITTED UNDER THE FUND'S AMENDED AND RESTATED LIMITED PARTNERSHIP AGREEMENT (AS AMENDED FROM TIME TO TIME, THE "***PARTNERSHIP AGREEMENT***") AND UNLESS THE INTERESTS ARE REGISTERED UNDER THE SECURITIES ACT OR EXEMPTED FROM SUCH REGISTRATION AND REGISTRATION UNDER ANY OTHER APPLICABLE SECURITIES LAW REQUIREMENTS.

NO PERSON HAS BEEN AUTHORIZED TO MAKE ANY REPRESENTATIONS OR GIVE ANY INFORMATION WITH RESPECT TO THE INTERESTS EXCEPT THE INFORMATION CONTAINED IN THIS MEMORANDUM, AND ANY REPRESENTATION OR INFORMATION NOT CONTAINED HEREIN MUST NOT BE RELIED UPON AS HAVING BEEN AUTHORIZED BY THE FUND, ITS GENERAL PARTNER, OR ANY OF THEIR RESPECTIVE PARTNERS, EMPLOYEES, OFFICERS, DIRECTORS OR AFFILIATES. THE DISTRIBUTION OF THIS MEMORANDUM AND THE OFFER AND SALE OF THE INTERESTS IN CERTAIN JURISDICTIONS MAY BE RESTRICTED BY LAW. FOR INFORMATION REQUIRED BY THE SECURITIES LAWS OF CERTAIN U.S. STATES AND CERTAIN JURISDICTIONS OUTSIDE OF THE U.S., PLEASE SEE THE OFFERING NOTICES BEGINNING IN SECTION XIV. THIS MEMORANDUM DOES NOT CONSTITUTE AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY THE INTERESTS IN ANY JURISDICTION TO ANY PERSON TO WHOM IT IS UNLAWFUL TO MAKE SUCH OFFER OR SOLICITATION IN SUCH JURISDICTION. THIS MEMORANDUM IS NOT, AND UNDER NO CIRCUMSTANCES IS IT TO BE CONSTRUED AS, A PROSPECTUS OR ADVERTISEMENT, AND THE OFFERING CONTEMPLATED IN THIS MEMORANDUM IS NOT, AND UNDER NO CIRCUMSTANCES IS IT TO BE CONSTRUED AS, A PUBLIC OFFERING OF THE INTERESTS.

THIS MEMORANDUM IS FOR THE CONFIDENTIAL USE OF ONLY THOSE PERSONS TO WHOM IT IS TRANSMITTED IN CONNECTION WITH THIS OFFERING. EACH RECIPIENT ACKNOWLEDGES AND AGREES THAT THE CONTENTS OF THIS MEMORANDUM AND RELATED DOCUMENTATION CONSTITUTE PROPRIETARY AND CONFIDENTIAL INFORMATION, THAT NEW LEAF VENTURE PARTNERS, L.L.C. ("***NEW LEAF***" OR THE "***MANAGEMENT COMPANY***") AND THE FUND DERIVE INDEPENDENT ECONOMIC VALUE FROM THEIR CONTENTS NOT BEING GENERALLY KNOWN, AND THAT THE MANAGEMENT COMPANY TAKES REASONABLE EFFORTS TO MAINTAIN THEIR SECRECY. IN ADDITION, EACH PERSON WHO RECEIVES THIS MEMORANDUM AGREES THAT ITS CONTENTS ARE A TRADE SECRET, THE DISCLOSURE OF WHICH IS LIKELY TO CAUSE SUBSTANTIAL AND IRREPARABLE COMPETITIVE HARM TO THE MANAGEMENT COMPANY AND THE FUND. BY ACCEPTANCE HEREOF, EACH RECIPIENT AGREES NOT TO TRANSMIT, REPRODUCE OR MAKE AVAILABLE TO ANYONE, IN WHOLE OR IN PART, THIS MEMORANDUM, ANY SUPPLEMENT HERETO OR ANY INFORMATION CONTAINED HEREIN OR THEREIN WITHOUT THE PRIOR WRITTEN CONSENT OF NEW LEAF VENTURE ASSOCIATES III, L.P. (THE "***GENERAL PARTNER***"), OR TO USE IT FOR ANY PURPOSE OTHER THAN EVALUATING A POSSIBLE INVESTMENT IN THE FUND. EACH PERSON WHO HAS RECEIVED A COPY OF THIS MEMORANDUM (WHETHER OR NOT SUCH PERSON PURCHASES ANY INTERESTS) IS DEEMED TO HAVE AGREED (I) TO RETURN THIS MEMORANDUM AND ANY SUPPLEMENT HERETO TO THE MANAGEMENT COMPANY UPON REQUEST IF SUCH PERSON HAS NOT PURCHASED AN INTEREST, (II) NOT TO DISCLOSE ANY INFORMATION CONTAINED IN THIS MEMORANDUM OR ANY SUPPLEMENT HERETO EXCEPT TO THE EXTENT THAT SUCH INFORMATION WAS (A) PREVIOUSLY KNOWN BY SUCH PERSON THROUGH A SOURCE (OTHER THAN THE FUND, ITS PARTNERS OR ANY AFFILIATES OR AGENTS THERETO) NOT BOUND BY ANY OBLIGATION TO KEEP CONFIDENTIAL SUCH INFORMATION, (B) IN THE PUBLIC DOMAIN THROUGH NO FAULT OF SUCH PERSON OR (C) LATER LAWFULLY OBTAINED BY SUCH PERSON FROM SOURCES (OTHER THAN THE FUND, ITS PARTNERS OR ANY AFFILIATES OR AGENTS THERETO) NOT BOUND BY ANY OBLIGATION TO KEEP SUCH INFORMATION CONFIDENTIAL AND (III) TO BE RESPONSIBLE FOR ANY DISCLOSURE OF THIS MEMORANDUM, ANY SUPPLEMENT HERETO, OR THE INFORMATION CONTAINED HEREIN OR THEREIN, BY SUCH PERSON OR ANY OF ITS EMPLOYEES, AGENTS OR REPRESENTATIVES.

PROSPECTIVE INVESTORS ARE URGED TO REQUEST ANY ADDITIONAL INFORMATION THEY MAY CONSIDER NECESSARY OR DESIRABLE IN MAKING AN INFORMED INVESTMENT DECISION. EACH PROSPECTIVE PURCHASER IS INVITED, PRIOR TO THE CONSUMMATION OF A SALE OF ANY INTERESTS TO SUCH PURCHASER, TO ASK QUESTIONS OF AND RECEIVE ANSWERS FROM THE MANAGEMENT COMPANY CONCERNING THE FUND AND THIS OFFERING AND TO OBTAIN ANY ADDITIONAL INFORMATION TO THE EXTENT THE MANAGEMENT COMPANY POSSESSES THE SAME OR CAN ACQUIRE IT WITHOUT UNREASONABLE EFFORT OR EXPENSE, IN ORDER TO VERIFY THE ACCURACY OF THE INFORMATION CONTAINED IN THIS MEMORANDUM OR OTHERWISE.

PROSPECTIVE INVESTORS ARE CAUTIONED NOT TO RELY ON THE PRIOR RETURNS SET FORTH HEREIN IN MAKING A DECISION WHETHER OR NOT TO PURCHASE THE INTERESTS OFFERED HEREBY. AN INVESTMENT IN THE FUND DOES NOT REPRESENT AN INTEREST IN ANY INDICATED INVESTMENT OR ANY INVESTMENT PORTFOLIO OF ANY RELATED OR OTHER INVESTMENT FUND, INCLUDING ANY INVESTMENT FUND MANAGED BY THE MANAGEMENT COMPANY OR ITS AFFILIATES. WHILE THIS MEMORANDUM INCLUDES REFERENCES TO A NUMBER OF RELATED AND AFFILIATED ENTITIES, INCLUDING CERTAIN AFFILIATED INVESTMENT POOLS AND VEHICLES, AN INVESTMENT IN THE FUND AS CONTEMPLATED HEREIN IS SEPARATE AND DISCRETE FROM ALL SUCH OTHER AFFILIATED INVESTMENT VEHICLES. FURTHER, ALTHOUGH THE PERFORMANCE OF SUCH OTHER AFFILIATED INVESTMENT VEHICLES MAY BE RELEVANT TO A GENERAL UNDERSTANDING OF THE GENERAL INVESTMENT EXPERIENCE AND PHILOSOPHY OF THE MANAGEMENT COMPANY AND ITS AFFILIATES, SUCH PERFORMANCE IS NOT AN INDICATOR OF THE RESULTS TO BE ACHIEVED BY THE FUND.

THE RETURN INFORMATION CONTAINED HEREIN HAS NOT BEEN AUDITED OR VERIFIED BY ANY INDEPENDENT PARTY AND SHOULD NOT BE CONSIDERED REPRESENTATIVE OF THE RETURNS THAT MAY BE RECEIVED BY AN INVESTOR IN THE FUND. CERTAIN FACTORS EXIST THAT MAY AFFECT COMPARABILITY INCLUDING, AMONG OTHERS, THE DEDUCTION OF FEES AND EXPENSES AND THE PAYMENT OF CARRIED INTEREST (WHICH MAY BE DIFFERENT FOR THE FUND) AS WELL AS OTHER FACTORS AS NOTED WITH SUCH INFORMATION. FURTHER, CERTAIN INFORMATION RESPECTING UNREALIZED RETURNS IS BASED ON PUBLIC MARKET VALUATIONS THAT, AMONG OTHER THINGS, HAVE BECOME INCREASINGLY VOLATILE AND AS A RESULT MAY NOT BE INDICATIVE OF THE CURRENT VALUE OR THE ACTUAL VALUE TO BE REALIZED FROM ANY PARTICULAR PORTFOLIO INVESTMENT.

PROSPECTIVE INVESTORS SHOULD NOT CONSTRUE THE CONTENTS OF THE MEMORANDUM AS LEGAL, TAX, REGULATORY, FINANCIAL, ACCOUNTING OR OTHER ADVICE. EACH PROSPECTIVE INVESTOR SHOULD MAKE ITS OWN INVESTIGATION AND CONSULT ITS OWN ADVISORS AS TO THE LEGAL, TAX, REGULATORY, FINANCIAL, ACCOUNTING AND RELATED MATTERS CONCERNING THE FUND, THE OFFERING AND AN INVESTMENT IN THE INTERESTS. THIS INVESTMENT INVOLVES A HIGH DEGREE OF RISK AND IS SUITABLE ONLY FOR INVESTORS WHO ARE SOPHISTICATED WITH FINANCIAL MATTERS AND FAMILIAR WITH THE RISKS ASSOCIATED WITH INVESTMENTS SIMILAR TO THE ONES DESCRIBED HEREIN. NONE OF THE FUND, THE GENERAL PARTNER, THE MANAGEMENT COMPANY OR ANY OF THEIR AFFILIATES IS MAKING ANY REPRESENTATION OR WARRANTY TO AN INVESTOR REGARDING THE LEGALITY OF AN INVESTMENT IN THE FUND BY SUCH INVESTOR OR ABOUT THE INCOME AND OTHER TAX CONSEQUENCES TO IT OF SUCH AN INVESTMENT.

UNLESS OTHERWISE INDICATED, ALL INFORMATION CONTAINED HEREIN RESPECTING RATES OF RETURN OR OTHER PERFORMANCE DATA, WHETHER REALIZED OR UNREALIZED, IS QUALIFIED BY THE RELEVANT APPENDICES, FOOTNOTES, AND ENDNOTES HEREIN AND IS ON A GROSS RETURN BASIS BEFORE GIVING EFFECT TO MANAGEMENT FEES, CARRIED INTEREST, OTHER EXPENSES AND TAXES, WHICH, IF GIVEN EFFECT TO, WOULD REDUCE SUCH RETURNS AND, IN THE AGGREGATE, ARE EXPECTED TO BE SUBSTANTIAL. WHERE NET RETURNS ARE PROVIDED, SUCH RETURNS GIVE EFFECT TO MANAGEMENT FEES, CARRIED INTEREST AND OTHER EXPENSES. FURTHER, INFORMATION RESPECTING INVESTMENT PERFORMANCE IS BASED ON CERTAIN INVESTMENT POSITIONS SELECTED AS REPRESENTATIVE AND ANALOGOUS TO THE TARGETED INVESTMENT CATEGORIES FOR THE FUND. SUCH INVESTMENT PERFORMANCE INFORMATION IS NOT REPRESENTATIVE OF INVESTMENT PERFORMANCE BY NEW LEAF AND ITS AFFILIATED INVESTMENT MANAGERS IN OTHER INVESTMENT ACTIVITIES, WHICH HAVE NOT BEEN INCLUDED HEREIN.

INVESTORS SHOULD CAREFULLY REVIEW THE INFORMATION CONTAINED IN THIS MEMORANDUM IN SECTION IX, “CERTAIN INVESTMENT CONSIDERATIONS,” AND SECTION X, “CERTAIN TAX AND ERISA CONSIDERATIONS.” INVESTMENT IN THE INTERESTS IS SUITABLE ONLY FOR SOPHISTICATED INVESTORS AND REQUIRES THE FINANCIAL ABILITY AND WILLINGNESS TO ACCEPT THE RISKS AND LACK OF LIQUIDITY INHERENT IN AN INVESTMENT IN THE INTERESTS. IN PARTICULAR, ONE OR MORE SUBSIDIARIES OF THE FUND OR OTHER ENTITIES IN WHICH THE FUND INVESTS DIRECTLY OR INDIRECTLY MAY QUALIFY AS “PASSIVE FOREIGN INVESTMENT COMPANIES” OR “CONTROLLED FOREIGN CORPORATIONS” FOR U.S. FEDERAL INCOME TAX PURPOSES, WHICH COULD RESULT IN ADVERSE TAX CONSEQUENCES TO INVESTORS THAT ARE U.S. PERSONS.

THIS MEMORANDUM CONTAINS A SUMMARY OF THE PARTNERSHIP AGREEMENT AND CERTAIN OTHER DOCUMENTS REFERRED TO HEREIN. HOWEVER, THE SUMMARIES IN THIS MEMORANDUM DO NOT PURPORT TO BE COMPLETE AND ARE SUBJECT TO AND QUALIFIED IN THEIR ENTIRETY BY REFERENCE TO THE ACTUAL TEXT OF THE RELEVANT DOCUMENT, COPIES OF WHICH WILL BE PROVIDED TO EACH PROSPECTIVE INVESTOR UPON REQUEST. EACH PROSPECTIVE INVESTOR SHOULD REVIEW THE PARTNERSHIP AGREEMENT, THE SUBSCRIPTION AGREEMENT AND SUCH OTHER DOCUMENTS FOR COMPLETE INFORMATION CONCERNING THE RIGHTS, PRIVILEGES AND OBLIGATIONS OF INVESTORS IN THE FUND. IN THE EVENT THAT THE DESCRIPTIONS OR TERMS OF THE MEMORANDUM ARE INCONSISTENT WITH OR CONTRARY TO THE DESCRIPTIONS OR TERMS OF THE PARTNERSHIP AGREEMENT, THE SUBSCRIPTION AGREEMENT OR OTHER DOCUMENTS, THE PARTNERSHIP AGREEMENT, THE SUBSCRIPTION AGREEMENT OR SUCH OTHER DOCUMENTS SHALL CONTROL. THE GENERAL PARTNER AND ITS AFFILIATES RESERVE THE RIGHT TO MODIFY THE TERMS OF THE OFFERING AND THE INTERESTS DESCRIBED IN THIS MEMORANDUM, AND THE INTERESTS ARE OFFERED SUBJECT TO THE GENERAL PARTNER’S ABILITY TO REJECT ANY COMMITMENT IN WHOLE OR IN PART.

CERTAIN INFORMATION IN THIS MEMORANDUM HAS BEEN OBTAINED FROM SOURCES BELIEVED TO BE RELIABLE ALTHOUGH NONE OF THE FUND, GENERAL PARTNER, THE MANAGEMENT COMPANY OR THEIR RESPECTIVE AFFILIATES GUARANTEE ITS ACCURACY, COMPLETENESS OR FAIRNESS. OPINIONS AND ESTIMATES MAY BE CHANGED WITHOUT NOTICE.

THE FUND IS OFFERING INTERESTS TO U.S. PERSONS THAT ARE “QUALIFIED PURCHASERS” AS DEFINED IN THE INVESTMENT COMPANY ACT AND “ACCREDITED INVESTORS” AS DEFINED IN THE SECURITIES ACT.

AN INVESTMENT IN THE FUND MAY BE SUBJECT TO INCREASING REGULATIONS AND GOVERNMENTAL OVERSIGHT, INCLUDING, FOR EXAMPLE, THE BANK SECRECY ACT AND THE USA PATRIOT ACT OF 2001, INCLUDING THEIR RESPECTIVE IMPLEMENTING REGULATIONS WHICH, AMONG OTHER THINGS, CONSTITUTE THE ANTI-MONEY LAUNDERING REGULATIONS. THERE CAN BE NO ASSURANCE THAT SUCH RULES WILL NOT REQUIRE VARIOUS INVESTOR DISCLOSURES TO, AMONG OTHERS, DOMESTIC AND FOREIGN GOVERNMENT AUTHORITIES.

YOUR INVESTMENT WILL BE DENOMINATED IN UNITED STATES DOLLARS ($) AND, THEREFORE, WILL BE SUBJECT TO ANY FLUCTUATION IN THE RATE OF EXCHANGE BETWEEN U.S. DOLLARS ($) AND THE CURRENCY OF YOUR OWN JURISDICTION. SUCH FLUCTUATIONS MAY HAVE AN ADVERSE EFFECT ON THE VALUE, PRICE OR INCOME OF YOUR INVESTMENT.

ALL SECURITIES INVESTMENTS RISK THE LOSS OF CAPITAL. NO GUARANTEE OR REPRESENTATION IS MADE THAT THE FUND WILL ACHIEVE ITS INVESTMENT OBJECTIVE. AN INVESTMENT IN THE FUND IS SPECULATIVE AND INVOLVES CERTAIN CONSIDERATIONS AND

CERTAIN INVESTMENT CONSIDERATIONS. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

THE FUND INTENDS TO CONDUCT ITS INVESTMENT ACTIVITIES THROUGH A NUMBER OF SUBSIDIARIES AND AFFILIATES THAT MAY BE ESTABLISHED FROM TIME TO TIME IN ONE OR MORE JURISDICTIONS, EACH OF WHICH MAY HAVE VARYING TAX EFFECTS ON THE FUND AND PARTNERS. AS SUCH THERE CAN BE NO ASSURANCE AS TO THE CONSEQUENCES OF SUCH ACTIVITIES. INVESTORS SHOULD CONSULT THEIR OWN TAX ADVISORS AS TO THE RISK OF AN INVESTMENT IN THE FUND. SEE ALSO SECTION X, "CERTAIN TAX AND ERISA CONSIDERATIONS."

PROSPECTIVE INVESTORS SHOULD REVIEW THE OFFERING NOTICES BEGINNING IN SECTION XIV FOR INFORMATION RELATING TO THE OFFERING AND SALES OF THE INTERESTS TO INVESTORS IN VARIOUS STATES OF THE U.S. AS WELL AS CERTAIN NON-U.S. JURISDICTIONS.

IN ACCORDANCE WITH U.S. TREASURY REGULATIONS GOVERNING PRACTICE BEFORE THE INTERNAL REVENUE SERVICE (CIRCULAR 230), THE FUND HEREBY INFORMS THE INVESTORS THAT (A) THE INFORMATION BELOW (OR OTHERWISE CONTAINED IN THIS DOCUMENT) IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, BY THE INVESTORS FOR THE PURPOSE OF AVOIDING PENALTIES THAT THE U.S. INTERNAL REVENUE SERVICE MAY ATTEMPT TO IMPOSE ON AN INVESTOR, (B) THE INFORMATION WAS WRITTEN TO SUPPORT THE PROMOTION OR MARKETING OF THE TRANSACTION OR MATTERS ADDRESSED BY THE WRITTEN INFORMATION AND (C) INVESTORS SHOULD SEEK TAX ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.

Forward-Looking Statements

CERTAIN INFORMATION CONTAINED IN THIS MEMORANDUM CONSTITUTES "FORWARD-LOOKING STATEMENTS," WHICH CAN BE IDENTIFIED BY THE USE OF FORWARD-LOOKING TERMINOLOGY SUCH AS "MAY," "WILL," "SHOULD," "EXPECT," "ANTICIPATE," "PROJECT," "ESTIMATE," "INTEND," "CONTINUE," OR "BELIEVE," OR THE NEGATIVES THEREOF OR OTHER VARIATIONS THEREON OR COMPARABLE TERMINOLOGY. DUE TO VARIOUS RISKS AND UNCERTAINTIES, INCLUDING, WITHOUT LIMITATION, THOSE SET FORTH IN SECTION IX "CERTAIN INVESTMENT CONSIDERATIONS", ACTUAL EVENTS OR RESULTS OR THE ACTUAL PERFORMANCE OF THE FUND MAY DIFFER MATERIALLY FROM THOSE REFLECTED OR CONTEMPLATED IN SUCH FORWARD-LOOKING STATEMENTS. WHILE ASSUMPTIONS UNDERLYING VARIOUS STATEMENTS AS TO FUTURE PERFORMANCE ARE BELIEVED TO BE REASONABLE IN NATURE, EXISTING AND PROSPECTIVE INVESTORS SHOULD MAKE THEIR OWN ASSESSMENTS AS TO SUCH ASSUMPTIONS AND THE ASSOCIATED RISKS, INCLUDING THE LIKELIHOOD OF THE FUND ACHIEVING CORRESPONDING RESULTS, ALL OF WHICH ARE SUBJECT TO RISKS AND UNCERTAINTIES MANY OF WHICH ARE BEYOND THE CONTROL OF THE FUND (SEE SECTION IX "CERTAIN INVESTMENT CONSIDERATIONS"). AS SUCH, NO ASSURANCE IS GIVEN AS TO THE REALIZATION OF ANY SUCH FUTURE PERFORMANCE. NO REPRESENTATION OR WARRANTY IS MADE AS TO FUTURE PERFORMANCE OR SUCH FORWARD-LOOKING STATEMENTS. UNLESS OTHERWISE INDICATED, INFORMATION CONTAINED HEREIN IS AS OF MARCH 31, 2014. THE DELIVERY OF THIS MEMORANDUM DOES NOT IMPLY THAT ANY OTHER INFORMATION CONTAINED HEREIN IS CORRECT AS OF ANY TIME SUBSEQUENT TO MARCH 31, 2014.

None of New Leaf Ventures I, L.P., New Leaf Ventures II, L.P., NLV-III, the Management Company or any of their affiliates have any affiliation with Credit Suisse nor any its affiliates (collectively, "Credit Suisse"). Credit Suisse has not compiled, reviewed or participated in the preparation of any of the performance or other information contained in this Memorandum and assumes no responsibility therefor. Consequently, in no respects *should Credit Suisse be considered to have approved or disapproved of any of the information set forth in this Memorandum. "Sprout", "Sprout Group" and the symbols associated therewith are registered trademarks of Credit*

Suisse. These trademarks remain the exclusive property of Credit Suisse. The Interests being offered by NLV-III are not sponsored, endorsed, promoted, offered or sold by Credit Suisse, and Credit Suisse makes no representation regarding the advisability of investing in NLV-III.

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I. EXECUTIVE SUMMARY

FUND OVERVIEW

New Leaf Ventures III, L.P. (*"**NLV-III**"* or the *"**Fund**"*) is being formed by New Leaf Venture Partners, L.L.C. (*"**New Leaf**"* or the *"**Management Company**"*), an established and proven leader in health care technology investing. NLV-III will be the seventh private equity fund focused on venture and growth stage investments in healthcare and life sciences companies raised by the partners of New Leaf. NLV-III is the successor fund to New Leaf Ventures I, L.P. (*"**NLV-I**"*) and New Leaf Ventures II, L.P. (*"**NLV-II**"*), which raised capital commitments of $310 million and $450 million respectively. The New Leaf funds follow four Sprout Capital funds that included over $1.0 billion of investments in healthcare technology companies.[1] In total, the New Leaf team has invested over $1.6 billion and have generated one of the industry's leading track records by consistently outperforming their peers in the healthcare venture capital market (based on Cambridge Associates benchmarks[2]) and exceeding relevant public market indices by substantial margins.[3,4]

The Fund will seek to invest in a diversified portfolio composed of an estimated 24 to 28 healthcare technology companies, most of which will be U.S. based and at the product development or commercialization phase. Fund investments will typically take the form of venture capital or growth capital transactions in private companies, or as structured transactions in small capitalization public companies. The Fund will establish meaningful ownership positions and in most cases will actively manage the investments with representation on the boards of directors. The Fund will seek to generate returns that significantly outperform relevant public market equity indices by creating a portfolio that optimally balances the risks, timelines, and capital intensity associated with developing and commercializing innovative healthcare technologies with the financial market realities that are the backdrop for a venture capital fund focused on this sector.

The Fund is targeting aggregate capital commitments from limited partners of **$375 million**.

THE NEW LEAF TEAM

New Leaf is one of the most respected, successful, and established brands in healthcare technology investing, a reputation built over the last 18 years by a highly experienced and stable team of partners. NLV-III will be managed by this team of 6 senior partners, 5 of whom have worked together continuously for a decade or more. These partners bring a strong combination of significant and relevant industry operating experience and successful venture capital investment experience to NLV-III.

The Managing Directors of NLV-III are Philippe Chambon MD PhD, Jeani Delagardelle, Ron Hunt, Vijay Lathi, and Liam Ratcliffe MD PhD. Philippe, Jeani, Ron, and Vijay have worked together for 15 years over six prior funds at New Leaf and the Sprout Group. Liam joined the

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[1] Sprout Group is a venture capital affiliate of Credit Suisse

[2] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices" including endnote C in Appendix 4 regarding information provided by Cambridge Associates.

[3] S&P500, S&P Healthcare, NASDAQ Composite, and Russell 3000. See endnote F in Appendix 4.

[4] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices; Appendix 3" (regarding the PME+ methodology) including endnotes B, D, E and F in Appendix 4.

New Leaf team five years ago and has made significant contributions to the NLV-II portfolio. Jim Niedel MD PhD has worked with the team continuously for over twelve years and will continue to be a senior member of the NLV investment team for NLV-III, but will change his status to Venture Partner with the closing of NLV-III. In this role, Jim will work full-time with NLV during the NLV-III investment period in building and managing the NLV-III portfolio, and he will continue with full oversight and portfolio management responsibilities for NLV-I and NLV-II. With 80+ years of venture investing experience and decades of operating experience in the industries in which they invest, this 6 member senior team (the "***Fund Managers***") brings highly relevant and complementary experience to bear on this Fund. This team of partners is further strengthened by a group of additional investment professionals who add highly relevant scientific and life sciences investment experience and have made significant contributions to the NLV-II portfolio.

The New Leaf team is distinctive in that its members have played a leadership role in the healthcare venture capital industry over the last two decades. During this time, the Fund Managers have demonstrated the ability to source high quality investments at all stages, including start-ups, follow-on private investments, company restructurings, and structured public investments. The Fund Managers source deals through a range of activities that rely on their deep relationships in academia, industry, and the investment community (private and public), resulting in differentiated and, in many cases, proprietary deal flow. Once initial investments are made, the Fund Managers are focused on building value in technology based healthcare companies by creating strong management teams and then collaborating with them to develop, manage, and execute capital efficient business plans. Through these efforts, the Fund Managers have earned a reputation as value-added investors and have created some of the best performing portfolios of healthcare technology investments in the industry.

LONG TERM TRACK RECORD

Over an 18 year period and across the portfolios of 6 distinct venture funds focused on healthcare technology investments, the Fund Managers have delivered net performance that has consistently outperformed venture industry benchmarks and relevant public equity market indices[5,6]. The Fund Managers' track record is notable for the following reasons:

- **Performance has been consistently top-quartile since the mid-1990s:**
  NLV-I, NLV-II and the healthcare technology portfolios in the Sprout Capital funds have invested over $1.6 billion in healthcare technology companies since 1995. Over nearly two decades, returns have consistently exceeded Cambridge Associates' top-

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[5] Except as otherwise expressly noted, all performance information contained herein, including rates of return, is as of March 31, 2014 and is unaudited. The performance information is based on the cumulative invested capital, cumulative cash dividends and realized and unrealized sales proceeds in portfolio companies. Where designated as "gross", the performance information is presented on a gross basis with regard to expenses and does not reflect deductions for any management fees, the general partner's carried interest or other expenses. Where designated as "net", the performance information is presented on a net basis after giving effect to management fees, the general partner's carried interest and other expenses. Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices" and the endnotes in Appendix 4 for a more detailed description of the performance of the NLV-I, NLV-II and the Sprout Funds. An investment in the Fund does not represent an interest in any indicated investment or any investment portfolio of any related or other investment fund, including any investment or fund managed by the Fund Managers. Disclosure of past performance herein is for informational purposes only and is not indicative of future results.

[6] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices; Appendix 3" including endnote C (regarding information provided by Cambridge Associates).

quartile benchmarks for U.S. venture capital healthcare and/or U.S. total venture capital.[7]

- **Exceeded relevant public equity indices by substantial margins on all realized funds:** Members of the New Leaf team invested $1.02 billion in the portfolios of healthcare technology investments in four Sprout Capital funds (Sprout Capital IX, L.P., Sprout Capital VIII, L.P., Sprout Capital VII, L.P. and Sprout Growth II, L.P.), and these are now fully realized (or near fully realized in the case of Sprout Capital IX, L.P.). The net annual IRR's on the healthcare technology portfolios in these funds outperformed the S&P 500 (568 – 2,258 bps), S&P Healthcare (302 – 2,064 bps), NASDAQ Composite (451 – 2,125 bps), and the Russell 3000 (502 – 2,215 bps) using the Public Market Equivalent Plus (PME+) methodology[8]. Although PME+ methodology is most informative when used to analyze funds whose returns are mature, the PME+ methodology shows that NLV-I is outperforming these same indices, and shows encouraging results for NLV-II despite its relative immaturity.

It is this consistently high level of return over an 18 year period, spanning several challenging investment cycles, that creates a truly unique track record within the venture capital sector.

The chart below illustrates details of the gross and net performance by fund.

Chart 1: Returns by Fund

As of March 31, 2014

($ in millions)

Fund:	Growth II HCT *	Sprout VII HCT *	Sprout VIII HCT *	Sprout IX HCT *	NLV-I	NLV-II
Fund Size:	$15M Fund	$95M Fund	$147M Fund	$690M Fund	$310M Fund	$450M Fund
Paid-In Capital	$15M	$95M	$147M	$690M	$303M	$407M
Vintage Year:	(1993 - 2007)	(1995 - 2011)	(1998 - 2012)	(2000)	(2005)	(2008)
First Investment	1995	1995	1998	2000	2005	2008
Gross Fund Returns						
Total Multiple [N]	4.4x	2.6x	1.7x	2.0x	2.1x	1.8x
Realized Multiple [N]	4.4x	2.6x	1.7x	2.2x	1.7x	2.0x
Total IRR [D]	44%	19%	10%	15%	19%	30%
Realized IRR [D]	44%	19%	10%	17%	23%	33%
Net Fund Returns						
Net Total Multiple [N]	3.69x *	2.17x *	1.49x *	1.66x *	1.75x	1.45x
Net Total IRR [D]	28.9% *	12.0% *	6.0% *	9.3% *	12.0%	16.7%
Net Distributed / Paid-In Multiple [F]	**3.69x** *	**2.17x** *	**1.49x** *	**1.55x** *	**0.51x**	**0.50x**
Net Distributed $s to LPs	*$56.3*	*$207.0*	*$218.7*	*$1,071.5*	*$154.7*	*$204.2*
Interim Fund Liquidity Metrics						
(Distributed + Public) / Paid-In Multiple [G]	--	--	--	1.62x	0.74x	1.18x
(Distributed + Liquid Public) / Paid-In Multiple [H]	--	--	--	1.58x	0.57x	0.75x
IRR Outperformance Versus Public Indices **						
PME+ (Basis Points over S&P 500 Healthcare Sector)	+2,064 bps	+302 bps	+441 bps	+776 bps	+201 bps	-187 bps
PME+ (Basis Points over S&P 500) **	+2,258 bps	+568 bps	+587 bps	+638 bps	+496 bps	+275 bps
PME+ (Basis Points over Russell 3000) **	+2,215 bps	+554 bps	+502 bps	+565 bps	+446 bps	+218 bps
PME+ (Basis Points over Nasdaq Composite) **	+2,125 bps	+554 bps	+725 bps	+451 bps	+181 bps	-21 bps

NLV and Sprout fund data as of March 31, 2014. Sprout fund statistics computed based on healthcare portfolio within Sprout.
* See Appendix 2 and endnotes A and E in Appendix 4. Based on synthetic funds with assumptions around recycling and fee structure.
** Based on Public Market Equivalent (PME+) methodology. See Appendix 3 and endnotes A, B, E and G in Appendix 4.

Please Section XIII: "Appendices" for definitions of terms and/or methodology.

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[7] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices" and endnotes B (regarding public indices) and C (regarding information provided by Cambridge Associates) in Appendix 4.

[8] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices", Appendix 3 (regarding the PME+ methodology) and to endnotes B, D, E and F in Appendix 4.

For a full overview of investment performance, please refer to Section III: Summary of Historical Investment Performance.

OPPORTUNITY IN THE HEALTHCARE SECTOR

The Fund Managers believe a number of macro market factors have aligned to create attractive and lasting conditions for NLV-III's targeted investment strategy in healthcare technology. These macro market factors include the following:

- **Strong and Sustained Growth in Global Healthcare Markets**: Healthcare is one of the strongest and most dynamic markets within the global economy, with powerful demographic forces expected to drive growth at rates that will outpace GDP in major economies for at least the next decade.[9] This steady and sustained market growth creates a positive macro environment for investment in the sector.

- **Significant Opportunity Created By Healthcare Reform & Restructuring:** Through at least the next decade, the healthcare industry will be going through a period of significant restructuring as government, private insurance companies, and employers implement broad reform initiatives that seek to slow the growth of healthcare spending and limit the threat this burden creates to their long term fiscal viability. In the U.S., the federal government laid the foundation for these changes with two key pieces of legislation: the *Patient Protection and Affordable Care Act* ("ACA") and the *Health Information Technology for Economic and Clinical Health Act* ("HITECH Act"), which are designed to reduce costs, improve quality, and significantly expand the percentage of the population with access to healthcare services. Importantly, a component of the legislation sets aside funding in the form of direct incentives to healthcare providers to be used to purchase technologies needed to meet the legislation's requirements. As part of healthcare reform, government and private payers will need to migrate their traditional fee-for-service reimbursement models towards more value-centered approaches that reward outcomes, efficiency, and reduction in waste. Payers are approaching this goal by slashing costs in areas where viable lower cost solutions are available, while at the same time investing much more in the adoption of innovative new products and solutions which can improve outcomes and deliver quantifiable value, even when considering their additional costs and premium pricing. During this period of substantial change in the healthcare system, the Fund Managers expect to see an unusually large number of opportunities to fund companies developing innovative and impactful new therapeutic products as well as tools and applications that enable the implementation and realization of healthcare reform's goals and objectives.

- **Rapid Acceleration in Innovation:** The Fund Managers believe an unprecedented period of medical innovation is emerging as decades of research into molecular mechanisms of disease is being translated into a steady stream of safer and more effective medicines and the biomarkers to guide their use. Importantly, these products are providing enormous improvements in both life expectancy and quality of life for patients with many serious, life-threatening diseases. Although they will come with premium pricing, these products can decrease the overall costs to the healthcare system by reducing reliance on equally costly, but less effective and more toxic treatments, by reducing clinic visits and hospital admissions and by controlling or curing disease so that the patient can return to a fully productive life. At the same time as this revolution in the biological sciences is unfolding, exponential increases in the ability to manage, process, and store information at low cost are coming out of the information technology (IT) industry. This rapid technological progress in IT is allowing the creation of entirely new systems and applications that will fundamentally improve how healthcare systems monitor and manage patients across the full range of care settings. The Fund Managers believe the massive expansion and integration of capabilities occurring in biology and information technology is enabling a period of innovation in healthcare that sets a uniquely positive environment for the investment of NLV-III.

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[9] CMS, OECD, Eurostat

- **More Favorable Regulatory Environment For New Drug Approvals:** Increasing numbers of FDA drug approvals and recently passed U.S. regulatory legislation are reflective of a more favorable regulatory environment. The number of new drug approvals by FDA in both 2012 (39 NDAs) and 2013 (27 NDAs) trended meaningfully higher compared to the previous 6 years and versus historic averages[10]. In addition, the *Food and Drug Administration Safety and Innovation Act* (FDASIA) was signed into law on July 9, 2012, providing for additional tools to enable the FDA to promote innovation by streamlining parts of the approval process and improving communication and administrative processes between the agency and pharmaceutical and biotech companies. Chief among these new tools is the "Breakthrough Therapy" designation. This new designation helps the FDA assist drug developers to expedite the development and review of new drugs with preliminary clinical evidence that indicates the drug may offer a substantial improvement over available therapies for patients with serious or life-threatening diseases. Overall, these initiatives and others, both in the U.S. and abroad (e.g., E.U. and Japan), have made the regulatory environment more favorable for investors in the biopharmaceutical sector, and have reduced some of the uncertainty and risk in a critical aspect of drug development.

- **Capital Markets And Industry Dynamics Are Favorable For New Investments & Exits:** Since the most recent peak in fundraising in 2008, it has been estimated that the life sciences venture capital fundraising has contracted by 68%, from $7.8 billion in 2008 to $2.5 billion in 2012[11]. The Fund Managers believe that there has been a corresponding decline in the number of active venture capital firms investing into life sciences companies (especially earlier stage), resulting in fewer investors competing for new deals. At the same time, large and mid-sized biopharmaceutical companies have become increasingly dependent on development stage companies as the source of innovation and new products to supplement R&D pipelines and stimulate future growth. Most of these big companies are committing a large and growing portion of their R&D budgets to external facing search and evaluation efforts that have the goal of obtaining assets through high value mergers, acquisitions, and partnerships, which disproportionally benefit smaller, venture-backed, development stage companies. In the years ahead, we believe that this trend is likely to continue, and possibly accelerate, driven by expected patent expirations on commercial products and continued low productivity of pharma R&D. The Fund Managers believe these dynamics offer venture and growth stage investors attractive conditions for both new investments and exits from existing investments for the foreseeable future.

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[10] Food and Drug Administration. Center For Drug Evaluation and Research

[11] Dow Jones; Fenwick & West Analysis in 2012 Trends in Terms of Life Science Venture Financings

The Fund Managers view this alignment of critical market factors as unprecedented. Each of these factors individually has a direct impact on the level of risk and the potential for returns in the healthcare technology sector. However, the positive trends in all of them occurring at the same time should create a uniquely positive environment to execute NLV-III's targeted strategy within the sector.

INVESTMENT STRATEGY

New Leaf's investment strategy is differentiated in the venture capital industry in terms of its sector focus, specific approaches within each sector, and the depth of experience and long-term track record that supports each element of the strategy. The Fund's primary focus will be on investments in the **Biopharmaceutical** and **Information Convergence** sectors, with a secondary focus on **Medical Devices** and **Biological Research Tools & Infrastructure**. Investments will be predominantly in the U.S., but could include a small number of investments in other parts of the world (e.g., Western Europe or Canada). The focus within each sector will be the following:

Biopharmaceuticals: As in NLV-I and NLV-II, biopharmaceutical investments will be the core focus for NLV-III and will comprise approximately 50% - 60% of the Fund. The Fund will typically invest in development stage and commercial stage private companies and in publicly traded small capitalization companies where the investments will be made mostly through structured transactions. The portfolio will emphasize companies developing targeted therapeutics that address molecular mechanisms of disease, where validated biomarkers can be utilized to positively bias probabilities of success and reduce time and cost of development compared to historical averages. These companies exemplify some of the key characteristics the Fund Managers seek across the portfolio - namely large, unmet medical needs, strong science, well differentiated technologies and high quality pre-clinical and clinical development programs led by experienced management teams.

The Fund Managers believe that NLV-III will have the opportunity to invest in compelling biopharmaceutical opportunities and that these will have attractive risk-return profiles for a number of reasons, including the following:

- For the past decade, biopharmaceutical companies have been shifting their research and development focus towards products that target mechanisms of disease at the molecular level. Clinical programs for these types of products are typically smaller, more capital efficient and have higher probabilities of success. These improvements are achievable because precise biomarker testing enables a focus on only those patients where the specific molecular mechanism is known to play an important role in the disease process. By including only these patients in the clinical programs for these targeted products, the probability of detecting critical efficacy signals is significantly increased, even with relatively small numbers of patients;

- Targeted development programs are benefiting from an improving regulatory environment, as the FDA is demonstrating clear interest in working constructively with companies to bring these types of high-impact therapeutics to market more quickly and efficiently. This spirit of cooperation was covered thoughtfully in a recent New England

Journal of Medicine editorial (November 2013), where Janet Woodcock, MD, the FDA's Director of the Center for Drug Evaluation and Research and other senior FDA staff members as co-authors, discussed the FDA's new breakthrough therapy designation that can be granted to expedite the review and approval of new therapies to treat people with serious or life threatening illnesses where inadequate treatment options exist. They state that "The genesis of the new designation can be traced to several emerging trends in drug discovery and development. Most notable is the rise of molecularly targeted therapies, often paired with companion diagnostics". The editorial goes on to say that "Once a drug is designated as a breakthrough therapy, the FDA commits to working particularly closely with the drug sponsor to devise the most efficient pathway for generating additional evidence needed about safety and efficacy". The breakthrough therapy designation was created under FDASIA in 2012, and since that time 26 breakthrough therapy designations have been granted on 80 requests;[12]

- The pharmaceutical industry's commercial model is also improving with the shift in focus to targeted therapeutics, as these therapies can: (a) provide significant improvements in efficacy and safety over current standards of care; (b) offer important clinical benefits in terms of increased life expectancy and improved quality of life; (c) positively impact high morbidity diseases, many of which have primarily expensive, but inadequate treatments available (e.g., cancer and autoimmune diseases); and (d) generate compelling economic benefits to payers, even when they carry premium pricing;

- Finally, large and mid-sized biopharmaceutical companies have recognized the inefficiency of their internal R&D efforts and have deemphasized many of their own expensive, high risk, "blockbuster" programs. Increasingly, these companies are "externalizing" a large portion of their R&D activity by acquiring, licensing, or partnering with smaller biotech companies that are focused on developing the novel targeted therapeutics mentioned above.

The Fund Managers believe the net result for investors is an improving risk-return equation for biopharmaceutical investments, which should translate into higher returns in the sector.

Information Convergence: Information convergence investments will be the second core focus for NLV-III, expected to comprise up to 25% of the Fund. Building on the leadership established during the NLV-II investment period along with significant experience from past Sprout funds, the Fund Managers will invest NLV-III in companies seeking to improve efficiency and reduce overall costs to the healthcare system through the generation, analysis, and application of information from research to diagnosis and delivery of care. Investments in this sector will be at the commercial stage at the time of initial investment, or will be expected to reach the commercial stage during the projected timeline of the investment.

Central to this opportunity is the acute structural deficit in the U.S., with healthcare liabilities the single largest contributor and the healthcare reform initiatives that were designed in part to address these critical fiscal issues. Broad scale deployment of new information technology will play a critical role in enabling the necessary structural changes to the healthcare system. The HITECH Act created a $25.9 billion[13] Federal Government funded catalyst for the adoption of information technology in healthcare in the U.S., and this is stimulating significant investment in upgrading the information infrastructure at the provider level. This industry-wide technology upgrade moves the vast majority of providers onto electronic systems, which offers immediate efficiencies to their businesses and lays the foundation for the adoption of new targeted information based applications in the future. These investments and legislative actions by the U.S. government, and the subsequent response by insurers, providers and patients, are driving a dramatic increase in spending on healthcare information technology (HIT), benefitting the companies providing technology solutions that reduce cost and waste, drive efficiency, and improve the quality of patient care.

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[12] New England Journal of Medicine, November 14, 2013: Expediting Drug Development – The FDA's New "Breakthrough Therapy" Designation

The opportunity in information convergence also benefits significantly from the technologies and infrastructure that have been developed and implemented outside of healthcare, such as cloud computing, wireless communications, web-delivered software-as-a-service, and sensor technology. Small companies drawing heavily off these existing technologies are able to optimize their product through rapid iterations driven by user feedback, thereby reducing risk and capital requirements, and leading to more predictable timelines, similar to what has been seen in the broader information technology arena. The Fund Managers believe that smaller, focused companies will play a key role in developing and deploying information based products that address discrete problems within the U.S. healthcare market, and that a large number of these will be compelling investment opportunities for NLV-III.

Medical Devices: Given the Fund Managers' view that the operating and exit environment for companies in this sector will be more challenging due to increased regulatory and reimbursement uncertainty, NLV-III will have somewhat less exposure to this sector than previous funds. The Fund will focus on investments in companies that are developing innovative and differentiated medical devices, targeting large market opportunities that offer the potential to meaningfully reduce overall patient treatment costs in high morbidity disease settings through substantial efficacy and safety benefits versus existing standards of care. Importantly, the focus will be on opportunities that have established regulatory approval pathways and clear regulatory precedents, or are already at the commercial stage at the time of initial investment. The objective will be to identify investment opportunities with later stage risk profiles that can be expected to thrive in the current environment. Although the number of deals in this sector is likely to be somewhat lower than in previous funds, with the later stage focus, it is likely that the size of investments in this sector will be larger.

Biological Research Tools & Infrastructure: The rapid growth of this sector is being fuelled by many of the same biomedical advances that are impacting health care more broadly, such as personalized medicine and DNA sequencing. Smaller companies have always been a prolific source of innovative new research tools, leading to high M&A interest among the large commercial players in this sector. Moreover, because new reagents and research tools are not subject to the risks of clinical trials, regulatory approvals or payer reimbursement it is possible to build high-gross margins businesses that reach break-even on manageable timelines and budgets. The Fund will approach this sector opportunistically and will seek to invest in a small

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[13] U.S. Department of Health and Human Services. Actuarial estimate as of January 2012.

number of commercial stage companies with novel and clearly differentiated products targeting defined and established high growth market segments.

DEAL FLOW AND INVESTMENT PROCESS

The Fund Managers have a proactive approach to deal sourcing, which targets both private and public opportunities. The established and proven sourcing activities rely on diverse networks of deal sources that have been built and cultivated over two decades and focus on identifying compelling healthcare technology investment opportunities, at attractive time points for investment. These efforts balance the inherent attractiveness of an innovative technology with the selection of the appropriate investment stage, offering an optimal risk-adjusted return potential and multiple paths to realization and liquidity.

The Fund Managers have refined and successfully executed this investment process over many years, and it is an integral part of the firm's culture. New Leaf's investment philosophy and process emphasize a team approach to maximizing investment returns, focusing the most appropriate resources within the firm to deal sourcing, rigorous investment analysis, deep involvement with portfolio companies and active management of financings and exits.

DISTINCTIVE FEATURES OF NEW LEAF

Over the last two decades, New Leaf has established itself as one of the premier brands in healthcare technology investing as a result of a powerful combination of:

- one of the most established and stable teams in the venture capital industry with deep and complementary operating and investing experience;

- a long term track record across portfolios of healthcare technology investments in six distinct venture funds and over $1.6 billion in total invested capital that has demonstrated consistent outperformance versus venture industry peers and relevant public market indices (S&P 500, S&P Healthcare, NASDAQ Composite, and Russell 3000)[14];

- an evolving investment strategy, focused on a diversified portfolio of investments across sectors, stages (start-ups to growth equity), and therapeutic areas that has proven to generate returns through both up and down phases of macro investment cycles;

- a hands-on approach to working with management teams as board members to optimize corporate strategy, develop and refine clinical, regulatory, and operating plans, recruit world-class talent, and drive business development activities that lead to value-maximizing follow-on financings, partnerships, and M&A transactions; and

- a reputation for intellectual rigor, hard work, value added contributions, and constructive collaboration that makes New Leaf a sought after lead investor by outstanding entrepreneurs and a preferred co-investor amongst a broad range of top quality investors.

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[14] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices" including endnotes B, C, F and G in Appendix 4.

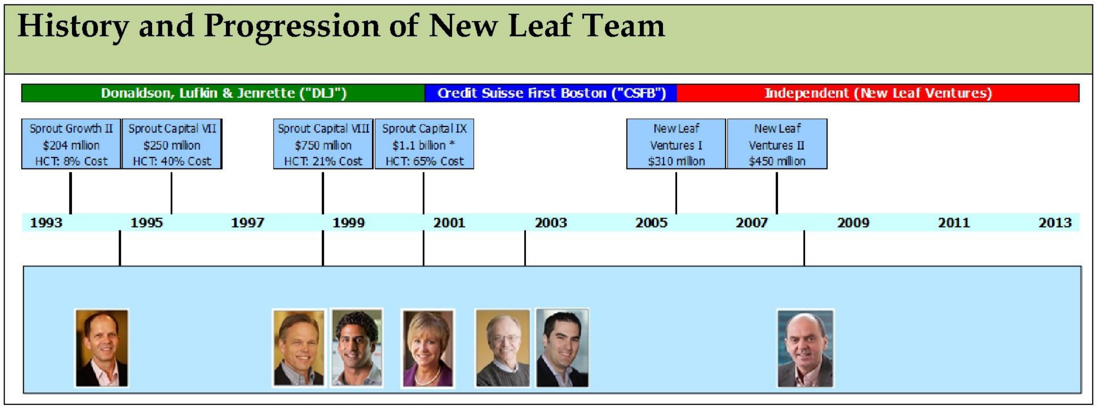
NLV-III Investment Opportunity

The objective of NLV-III is to invest in a portfolio of healthcare technology companies that offer attractive risk-adjusted returns. The companies that comprise the portfolio will be selected and managed by a team of highly experienced senior partners who have developed and proven their investment process over many years and multiple funds. The investment strategy for NLV-III is similar to the strategies pursued in prior funds, in that it will have a core focus on biopharmaceutical investments with a balance of investments across other healthcare technology sectors. Given the strength and stability of the team, the consistency and the depth of the track record, and the positive market forces and investment conditions that are expected to be in place during the life of the Fund, the Fund Managers believe NLV-III offers investors an opportunity for attractive returns.

II. THE TEAM

NLV-III will be managed by the New Leaf team, which currently manages NLV-I, NLV-II, and provides sub-advisory services managing the remaining healthcare technology investments in the Sprout Funds. The team of six senior partners, five of whom have worked together continuously for over a decade, stands out in the industry for its depth of accomplishments, track record of consistent investment success, and its organizational stability. Each of the senior partners has a strong combination of significant and relevant industry operating experience and venture capital investment experience from one or more of the Fund's targeted sectors. The New Leaf team is further strengthened by a group of experienced investment professionals who add highly relevant scientific backgrounds and investment experience.

The following timeline shows the history and progression of the New Leaf team:


History and Progression of New Leaf Team

Donaldson, Lufkin & Jenrette ("DLJ")
Credit Suisse First Boston ("CSFB")
Independent (New Leaf Ventures)
Sprout Growth II $204 million HCT: 8% Cost
Sprout Capital VII $250 million HCT: 40% Cost
Sprout Capital VIII $750 million HCT: 21% Cost
Sprout Capital IX $1.1 billion * HCT: 65% Cost
New Leaf Ventures I $310 million
New Leaf Ventures II $450 million
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013

SENIOR TEAM

Philippe Chambon, MD, Ph.D., (55), Managing Director, helped found New Leaf in 2005. Philippe joined Sprout in 1995 and since that time has been an active investor in all three sectors of interest for NLV-III. His investments have spanned all stages including six start ups and several later stage growth equity investments and one buy-out. Philippe is currently focused on New Leaf's Information Convergence sector and late stage biopharmaceutical investments. Philippe is currently on the boards of directors of Treato, Truveris, Karos Pharmaceuticals, Principia BioPharma and VaxInnate. He was previously on the boards of NxStage Medical (NASDAQ: NXTM), Auxilium (NASDAQ: AUXL), ePocrates (NASDAQ: EPOC, acquired by athenahealth), Nuvelo (NASDAQ: NUVO), Sapient Health Network (acquired by WebMD), Spotfire (acquired by Tibco Software), and Combichem (acquired by DuPont). He also led our investment in, and was a board observer at, Audax Health (acquired by UnitedHealth/Optum). Immediately prior to joining Sprout, Philippe was a Manager in the healthcare practice of the Boston Consulting Group. In that capacity, he managed strategy and business re-engineering assignments with clients in the pharmaceutical, biotech and insurance industry. Previously, Philippe was an executive with Sandoz Pharmaceutical for seven years, where he built and led an organization responsible for late stage clinical project management, portfolio management, and pre-marketing and pharmacoeconomics activities. He conducted graduate research in molecular immunology at The Pasteur Institute and earned an M.D. and Ph.D. from the University of Paris, and an M.B.A. from Columbia University.

Jeani Delagardelle, (57), Managing Director, helped found New Leaf in 2005. She joined Sprout in 2000. At New Leaf, Jeani leads the Medical Device investment effort. Jeani is currently on the boards of directors of Access Closure, Altura, Cardiokinetix, Direct Flow Medical, Intrinsic Therapeutics, ReShape Medical, and Spiracur. She was previously on the boards of directors of Interlace (NLV-I company acquired by Hologic), Epicor (acquired by St. Jude), Visiogen (acquired by Abbott), PercuSurge (acquired by Medtronic), and NxStage Medical (NASDAQ: NXTM). Prior to joining the healthcare investment team at Sprout, Jeani was a General Partner at Weiss, Peck & Greer Venture Partners ("WPGVP") where she focused on healthcare investments. Before joining the venture industry, Jeani spent 16 years in senior marketing and general management positions in both the medical device and pharmaceutical industries. She was Vice President of Global Marketing for Target Therapeutics, held several senior management positions within the Medi-tech division of Boston Scientific, and served as the Director of Business operations for Roche Pharmaceuticals. Jeani earned an A.B. in Clinical Psychology from Occidental College and an M.B.A. from the University of California at Irvine.

Ron Hunt, (49), Managing Director, joined Sprout in 1998 and helped found New Leaf in 2005. He has played significant role in the firm's investment activities in later stage biopharmaceuticals and has also contributed to the activities in each of the other sectors. Ron is currently on the boards of Durata Therapeutics (NASDAQ: DRTX), IlluminOss Medical, Relypsa (NASDAQ: RLYP), and SpineWave. Ron was previously on the boards of Cerexa (NLV-I company acquired by Forest Laboratories), Stromedix, Inc. (NLV-I company acquired by Biogen Idec), Aspreva Pharmaceuticals (NASDAQ: ASPV, acquired by Galenica, Inc.), Phase Forward (NASDAQ: PFWD, acquired by Oracle), and Pathology Partners (acquired by Caris Group). Before joining Sprout, he spent a combined 12 years in the pharmaceutical industry in operating roles and as a management consultant with The Healthcare Group (a division of the Interpublic Group of Companies) and Coopers & Lybrand Consulting. He gained eight years of operating experience in various commercial roles working for SmithKline Beecham and Johnson & Johnson. Ron earned a B.S. from Cornell University and an M.B.A. from The Wharton School of the University of Pennsylvania.

Vijay Lathi, (41), Managing Director, helped found New Leaf in 2005 and joined Sprout in 1998. Vijay's activities are focused primarily on information convergence, although historically he has been involved in investments across all sectors. He is currently on the boards of directors of AwarePoint, Oxford Immunotech (NASDAQ: OXFP), iRhythm Technologies, Kit Check, TigerText and XDx, while maintaining board observer status with Labcyte. Vijay was previously on the boards of Advanced Cell Diagnostics, Ilypsa (acquired by Amgen) and Relypsa (NASDAQ: RLYP). Prior to joining Sprout, Vijay spent one year as an analyst in the healthcare venture capital group at Robertson Stephens where he reviewed investments spanning medical devices, therapeutics and healthcare information technology. Prior to Robertson Stephens, Vijay spent approximately one and a half years as an analyst at Cornerstone Research, a business consulting firm focused on financial and econometric analysis. He earned an M.S. in Chemical Engineering from Stanford University and a B.S. in Chemical Engineering from MIT, with a focus on applications of engineering to the life sciences.

James Niedel, MD, Ph.D., (70), Venture Partner, joined Sprout in May 2002 and helped found New Leaf in 2005. Jim will change his status to Venture Partner in NLV-III with the closing of the new fund. In this role, Jim will work full-time as a senior member of the NLV investment team working on new investments, and he will continue with full oversight and portfolio management responsibilities for NLV-I and NLV-II. Jim is currently on the boards of directors of Chimerix (NASDAQ: CMRX, former Chairman) and Tioga. He was previously on the boards of Intarcia Therapuetics (now currently a Board observer), Sirna Therapeutics (NASDAQ: RNAI, acquired by Merck in 2006 for $1.1 billion), where he served as Chairman; Oriel Therapeutics (acquired by Novartis in 2010), where he served as Executive Chairman, and Pearl Therapeutics (acquired by AstraZeneca in 2012). Prior to joining Sprout, Jim was Chief Science and Technology Officer for GlaxoSmithKline ("GSK"). From 1995 to 2001, he led Global Research and Development, Information Technology and Product Strategy and was a member of the board of directors of Glaxo Wellcome plc. From 1988 to 1995 Jim was Vice President, Research and Senior Vice-President R & D for the U.S. subsidiary of Glaxo. During his nearly 13 years with the Company, he oversaw the discovery, development and/or registration of over 20 products marketed by GSK, including those for: HIV, hepatitis B, asthma/COPD, migraine, BPH, irritable bowel syndrome, smoking cessation, depression, chemotherapy-induced nausea and vomiting, breast cancer, herpes and malaria. Prior to GSK, Jim was Professor of Medicine, Chief of the Division of Clinical Pharmacology and Principal Investigator on studies of mechanisms of cancer and inflammation at Duke Medical School, where he had completed an Internal Medicine residency and a Hematology-Medical Oncology fellowship. Jim received his M.D. and Ph.D. (Biochemistry) degrees from the University of Miami, was selected a Searle Scholar and is a Fellow of the Royal College of Physicians (London).

Liam Ratcliffe, MD, Ph.D., (50), Managing Director, joined New Leaf in September 2008 and concentrates on biopharmaceutical investing. He is currently on the boards of directors of Array BioPharma (NASDAQ: ARRY), Neuronetics, Karus Therapeutics, Afferent, Calchan and Convergence, the latter three investments resulting from spin-outs from Roche (Afferent) and GSK (Calchan & Convergence), respectively. Prior to joining New Leaf, Liam previously served as Senior Vice President and Development Head for Pfizer Neuroscience, as well as Worldwide Head of Clinical Research and Development. Additional positions during his 12 years at Pfizer included Vice President of Exploratory Development for the Mid West region, and Head of Experimental Medicine at Pfizer's Sandwich, UK Laboratories. As Head of Neurosciences, Liam was responsible for the development of several successful late-stage projects and marketed products, including Lyrica, Chantix and Geodon. In previous roles, he gained extensive experience in early drug development and translational research across multiple therapeutic areas, including inflammation, pain, cardiovascular disease, infectious diseases and genitor-urinary medicine. Liam began his career in the pharmaceutical industry in a medical marketing role at Roche in South Africa. He received his M.D. degree and Ph.D. degree in immunology from the University of Cape Town and his M.B.A. degree from the University of Michigan. Liam completed his internal medicine training and fellowship in Immunology at Groote Schuur Hospital and associated teaching hospitals in Cape Town, South Africa.

OTHER INVESTMENT PROFESSIONALS

Kathy LaPorte, (52), Venture Partner, is an angel investor in the Digital Health space focusing on evaluating and mentoring start-ups developing digital technology solutions for healthcare consumers, providers, payers and the pharmaceutical/medical device industries. Kathy is affiliated with Health Tech Capital and is a Venture Partner with New Leaf, collaborating on sourcing of opportunities with an emphasis on the Information Convergence sector. Kathy was one of the founders of New Leaf upon its spin out from the Sprout Group in 2005. Kathy joined the Sprout Group in 1993 and became a General Partner in 1994. Between 1987 and 1993, she was a Principal at Asset Management Company, a venture capital firm focused on early stage investments. Kathy received an M.B.A. from Stanford University Graduate School of Business (Arjay Miller Scholar), and a B.S., summa cum laude, Phi Beta Kappa from Yale University.

Mark Charest, Ph.D., (36), Portfolio Manager, joined New Leaf in 2012. Previously, Mark was an Associate and Kauffman Fellow at Panorama Capital (2010-2012) focused on life sciences investments. Mark previously worked as a Consultant at ZS Associates (2009) and as an Associate at Great Point Partners (2007-2009), a healthcare-focused public and private equity investment firm. Prior to that, Mark held an operating role as a Medicinal Chemistry Lab Manager at Novartis Institutes for BioMedical Research (2004-2007). Mark received his Ph.D. in Chemistry and Chemical Biology from Harvard University as a National Science Foundation Graduate Research Fellow.

Mike Dybbs, Ph.D., (39), Principal, joined New Leaf in 2009 and was promoted to Principal in 2012. Mike is currently on the boards of directors of Advanced Cellular Diagnostics and Versartis. Prior to joining New Leaf, Mike was a Principal at the Boston Consulting Group (BCG) where he was a core member of their Health Care practice. Mike graduated magna cum laude from Harvard University with an AB in biochemical sciences and received his Ph.D. in molecular biology and genetics from UC Berkeley, where he was awarded a Howard Hughes Medical Institute fellowship. His research had been published in peer-reviewed journals, including Neuron, Science and Nature.

Eric Kim, (28), Associate, joined New Leaf in December 2013. From 2011 through 2013, Eric was a Private Equity Associate at Francisco Partners, where he focused on diligence and company oversight efforts on the firm's healthcare information technology portfolio. Prior to joining Francisco Partners, Eric worked for three years at McKinsey & Company as a Senior Business Analyst in their Corporate Finance Practice. Eric received his dual B.A. in Mathematical Methods in the Social Sciences and Economics from Northwestern University.

Isaac Manke, Ph.D., (37), Portfolio Manager, joined New Leaf in 2009 as an Associate and was promoted to Public Investment Director in 2012. Prior to joining New Leaf, Isaac was an Associate in the Global Biotechnology Equity Research group at Sanford C. Bernstein. Previously, Isaac worked as an Associate in the Biotechnology Equity Research group at Deutsche Bank and was a Senior Analyst at Health Advances, a biopharmaceutical and medical device strategy consulting firm. Isaac received a B.A. in Biology and a B.A. in Chemistry at Minnesota State University (Moorhead), and a Ph.D. in Biophysical Chemistry and Molecular Structure at the Massachusetts Institute of Technology (MIT). Isaac's discoveries led to several publications in top journals, including Science and Cell, and were selected by Science as one of the "2003: Signaling Breakthroughs of the Year". These discoveries also resulted in four issued patents.

FINANCE AND OPERATIONS

Craig L. Slutzkin, (39), is Chief Financial Officer and manages the back office, compliance and administrative functions for New Leaf. Craig joined Sprout as Vice President and the head of its back office operations in August 2002 and transitioned to New Leaf at the time of the spin-out. Prior to joining Sprout, he spent over seven years in the audit and assurance practices of Arthur Andersen and Ernst & Young in New York, attaining the position of Senior Manager. While at Andersen and Ernst & Young, clientele included various multi-strategy private equity and venture capital fund firms as well as top tier investment banks. Craig received his M.B.A. in finance from Columbia Business School and received a B.A. in Accounting and Information Systems from Queens College. He is a certified public accountant and a member of the American Institute of Certified Public Accountants.

INDUSTRY ADVISORS

The Fund Managers work closely with industry professionals who are experts in New Leaf's fields of interest and are willing to work closely with the Fund Managers on an as needed basis to provide their perspectives on topics and issues that are relevant to due diligence on new investments, on-going issues that arise in the management of existing portfolio companies, and longer term fund strategy. New Leaf's advisors are all prominent in their fields, and hold senior positions within leading corporations and academic institutions. These experts provide New Leaf and its portfolio companies with their own invaluable insights, but equally importantly open up their networks of contacts in ways that vastly expand and strengthen New Leaf's own network.

Therapeutics Advisors

New Leaf works with a broad range of industry advisors to support its investment activities in therapeutics. The Fund Managers work on an as needed basis with a large group of advisors that includes contacts from industry and academia that each of the investment professionals within the firm has cultivated through their own professional and academic experiences. The Fund Managers solicit input from advisors on an as needed basis to get valuable input on specific scientific, clinical, and commercial issues and topics relevant to diligence on new investment opportunities, and to the management of existing portfolio companies. This network gives New Leaf timely and valuable access to some of the world's leading academic scientists and experienced practitioners/executives from industry, and brings their subject matter expertise to bear across the myriad of topics that are critical to New Leaf's decision making in the therapeutics sectors. Because of the breadth of topics where this type of outside input is required, and due to the fact that the science and technology is evolving rapidly in most of these fields, New Leaf has not created a formal advisory board for therapeutics

Information Convergence Advisory Board

The Fund Managers have assembled an additional advisory board to support activities in Information Convergence. This group of advisors has a breadth of experience in the development and deployment of new information technologies that are reshaping healthcare.

Their collective experience is from industry, including leading large and entrepreneurial corporations, as well as from the provider side, including senior administration of one of the world's most prominent and forward-thinking teaching hospitals. These professionals include the following:

John Halamka, M.D., is a physician and technology leader who focuses on electronic health records as well as secure sharing of healthcare data for care coordination, population health, and quality improvement. He is currently Chief Information Officer of Beth Israel Deaconess Medical Center and also a practicing Emergency Physician and Professor at Harvard Medical School. He is current Chairman of the New England Healthcare Exchange Network (NEHEN), co-chair of the national HIT Standards Committee, and co-Chair of the Massachusetts HIT Advisory Committee.

Lee Newcomer, M.D., Senior Vice President, UnitedHealthcare with strategic responsibility for Oncology, Genetics and Women's Health. Dr. Newcomer returned to UnitedHealthcare in 2006 to focus on combining clinical, financial and administrative incentives for improved and affordable cancer care. From 1991 to 2000, Dr. Newcomer was the chief medical officer at UnitedHealthcare. He is a board certified medical oncologist and former chairman of Park Nicollet Health Services and was previously a medical director for CIGNA Health Care of Kansas City. Dr. Newcomer was a founding executive of Vivius, a consumer directed venture that allowed consumers to create their own personalized health plans.

Stephen Oesterle, M.D., Senior Vice President for Medicine and Technology, Medtronic Inc. Dr. Oesterle is focused on the formation of technological strategies and continued development of relationships with the world's medical communities. He previously served as an Associate Professor of Medicine at the Harvard University Medical School and as Director of Invasive Cardiology Services at Massachusetts General Hospital.

Marcia Radosevich, Founder and CEO of HPR, a HCIT company that was sold to McKesson. Her prior experience was with Managed Health Care Services, The Travelers Insurance Companies, and Health Data Institute (a healthcare consulting firm).

Anand Shroff, Chief Technology and Product Officer and Co-Founder, Health Fidelity, Inc. Prior to joining Health Fidelity, Mr. Shroff was VP of HIE and EHR Products at Optum (a division of UnitedHealthcare). He came to Optum by way of acquisition of Axolotl Corporation, a leader in the health information exchange (HIE) space. Anand was also a founding member of the Oracle Healthcare team, and was responsible for Oracle's healthcare product portfolio that included healthcare analytics, clinical data management, and terminology mediation solutions.

David Watson, Vice President of Healthcare Product Strategy, Oracle. Previously he was the Chief Operating Officer of MedeAnalytics, and prior to that was Senior Vice President and Chief Technology Officer of Kaiser Permanente. Prior to Kaiser, Mr. Watson served in a variety of executive IT roles at Baxter Healthcare, Allergan, Northrup Grumman, and Mattel. He is a senior HCIT executive with 25 years of experience delivering client facing solutions in the broad areas of application development, infrastructure engineering, business consulting, strategy, architecture and operations.

David Whittlinger, Executive Director, New York eHealth Collaborative. Prior to working with NYeC, served as the Director of Healthcare Device Standards and Interoperability for the Intel Corporation in its Digital Health Group. Mr. Whitlinger was responsible for Intel's healthcare device interoperability strategies and standards development. He has also led a large, cross-industry consortium, the Continua Health Alliance, focused on the establishment of an ecosystem of interoperable, personal telehealth systems. Prior to establishing the Healthcare Device Standards Group, he worked on a wide variety of wireless standards within Intel.

III. SUMMARY OF HISTORICAL INVESTMENT PERFORMANCE

The Fund Managers' long term track record in healthcare technology investing clearly establishes the team as one of the most successful in the venture capital industry over the last two decades. Over an 18 year period and across the portfolios of six distinct venture funds focused on healthcare technology investments, the Fund Managers have delivered net performance that has consistently outperformed venture industry benchmarks and relevant public equity market indices[15,16]. The Fund Managers' track record is notable for the following reasons:

- **Performance has been consistently top-quartile since the mid-1990s:** NLV-I, NLV-II and the healthcare technology portfolios in the Sprout Capital funds have invested over $1.6 billion in healthcare technology companies since 1995. Over this time, The Fund Managers' returns have consistently exceeded Cambridge Associates' top-quartile benchmarks for U.S. venture capital healthcare and/or U.S. total venture capital.[16]

- **Exceeded relevant public equity indices by substantial margins on all realized funds:** The Fund Managers invested $1.02 billion in the portfolios of healthcare technology investments in four Sprout Capital funds (Sprout Capital IX, L.P., Sprout Capital VIII, L.P., Sprout Capital VII, L.P. and Sprout Growth II, L.P.), and these are now fully realized (or near fully realized in the case of Sprout Capital IX). The net annual IRR's on these four funds outperformed the S&P 500 (568 – 2,259 bps), S&P Healthcare (302 – 2,066 bps), NASDAQ Composite (451 – 2,125 bps), and the Russell 3000 (502 – 2,215 bps) using the Public Market Equivalent Plus (PME+) methodology[17]. Although PME+ methodology is most informative when used to analyze funds whose returns are mature, the PME+ methodology shows that NLV-I is outperforming these same indices, and shows encouraging results for NLV-II despite its relative immaturity.

It is this consistently high level of return over an 18 year period, spanning several challenging investment cycles, that creates a truly unique track record within the venture capital sector.

INVESTMENT PERFORMANCE WITHIN INDIVIDUAL FUNDS

The New Leaf team has invested over $1.67 billion in 126 healthcare technology companies within 6 distinct funds since 1995. These funds included NLV-I and NLV-II and the healthcare technology investments in four Sprout Capital funds (Sprout Capital IX, L.P., Sprout Capital VIII, L.P., Sprout Capital VII, L.P., and Sprout Growth II, L.P., together the "***Sprout Funds***"). In aggregate, the team has exited or partially exited investments in 92 companies, generating gross realizations of over **$2.6 billion** and a gross realized cash-on-cash return and internal rate of return (IRR) of **2.1x** and **17%**, respectively. Corresponding net returns on the portfolios in each of these funds are provided in Appendix 2.

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[15] Please see Section XIII: "Appendices" and the endnotes in Appendix 4. Disclosure of past performance herein is for informational purposes only and is not indicative of future results.

[16] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices" and endnote C (regarding information provided by Cambridge Associates) in Appendix 4.

[17] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices; Appendix 3" (regarding the PME+ methodology) and endnotes B, D E and F in Appendix 4.

New Leaf Funds

NLV-I has capital commitments of $310 million, and the Fund Managers began investing in mid-2005. The fund completed its new investment period in early 2008 with a portfolio of 22 companies. NLV-I has fully realized 13 investments, and there are nine active investments in companies and contingent value rights (CVRs) from three of the realized investments remaining in the fund. NLV-I is a relatively young fund, with the majority of the cost basis still at work, and to date has generated a gross realized IRR of 23%, and a gross total IRR of 19%. NLV-I has a net total multiple of 1.76x and a net IRR of 12.1%. NLV-I has a distributed to paid-in-capital ratio of 0.51x, and the Fund Managers believe the fund has significant future returns potential from the remaining active investments in the portfolio as well as from potential payments from CVRs on three realized investments. NLV-I is in the top quartile of funds tracked by Cambridge Associates for U.S. healthcare venture capital in the 2005 vintage year.

NLV-II has capital commitments of $450 million, and the Fund Managers began investing in 2008. The fund will complete its new investment period by mid-2014. NLV-II currently has a portfolio consisting of 35 companies. NLV-II has realized or partially realized 13 investments, and there are 22 other active investments and a small public portfolio remaining in the fund. NLV-II is still an immature fund in terms of level of realizations, and to date has generated a gross realized IRR of 34%, and a gross total IRR of 30%. NLV-II has a net total multiple of 1.44x and a net IRR of 16.4%. NLV-II has a distributed to paid-in-capital ratio of 0.50x, and the Fund Managers believe the fund has significant future returns potential from the remaining active investments in the portfolio. The Fund Managers believe that NLV-II has unusually positive liquidity characteristics for a life sciences focused venture capital fund of its age, with just over 65% of the fund's current carrying value in the form of public securities (as of March 31, 2014). NLV-II's current performance places the fund in the top quartile of funds tracked by Cambridge Associates for U.S. venture capital in the 2008 vintage year.

Additionally, over the investment period of NLV-I, the net annual IRR is outperforming relevant public market indices when compared on a public market equivalent basis (PME+). NLV-II's net annual IRR shows encouraging results thus far for a relatively immature fund[18]. The range of outperformance for each of these portfolios versus the S&P 500, S&P Healthcare, NASDAQ Composite, and the Russell 3000 through March 31, 2014 is the following:

	Net IRR Outperformance vs. Public Indices (PME+ Methodology)			
	S&P 500	**S&P Healthcare**	**NASDAQ Composite**	**Russell 3000**
New Leaf Ventures I, L.P.	+496 bps	+201 bps	+181 bps	+446 bps
New Leaf Ventures II, L.P.	+275 bps	-187 bps	-21 bps	+218 bps

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[18] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices; Appendix 3" and the endnotes thereto (regarding the PME+ methodology).

Sprout Capital Healthcare Technology Portfolios:

Since 1995, members of the New Leaf team made all of the healthcare technology investments in the Sprout Funds while they were part of the investing team at the Sprout Group. The Sprout Funds were venture capital funds that were diversified across several sectors including information technology, communications, services, and healthcare technology. The healthcare technology investments in the four Sprout Funds included **$1.019 billion** in total cost, which was invested in new and follow-on investments in 69 companies from 1995 to 2013. The healthcare technology investments in the first three of these funds are now fully realized, and those in Sprout IX are nearly fully realized. To date, across these four funds, the New Leaf team has generated $1.997 billion of realizations in the aggregate (63 realized investments), and there is $68 million in unrealized value in six unrealized investments.

The net annual IRR performance on the healthcare technology portfolios in each of the Sprout Funds would place them in the top quartile of all healthcare venture capital funds tracked by Cambridge Associates in each of the vintage years for which they have established a benchmark[19]. Additionally, over an 18 year period the net annual IRR on these portfolios outperformed relevant public market indices when compared on a public market equivalent basis (PME+)[20]. The range of outperformance for each of these portfolios versus the S&P 500, S&P Healthcare, NASDAQ Composite, and the Russell 3000 through March 31, 2014 is the following:

	Net IRR Outperformance vs. Public Indices (PME+ Methodology)			
	S&P 500	**S&P Healthcare**	**NASDAQ Composite**	**Russell 3000**
Sprout Capital IX, L.P. *	+638 bps	+776 bps	+451 bps	+565 bps
Sprout Capital VIII, L.P. *	+587 bps	+441 bps	+725 bps	+502 bps
Sprout Capital VII, L.P. *	+568 bps	+302 bps	+554 bps	+554 bps
Sprout Growth II, L.P. *	+2,258 bps	+2,064 bps	+2,125 bps	+2,215 bps

*Healthcare Technology Portfolios

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[19] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices" and the endnote C in Appendix 4 regarding information provided by Cambridge Associates.

[20] Please refer to Section III: "Summary of Historical Investment Performance" and Section XIII: "Appendices; Appendix 3" and the endnotes thereto (regarding the PME+ methodology).

Current gross and net portfolio returns for the New Leaf funds and for the healthcare technology portfolios in the Sprout Funds are detailed in the following chart:

Chart 1: Returns by Fund

As of March 31, 2014

($ in millions)

Fund:	**Growth II HCT** *	**Sprout VII HCT** *	**Sprout VIII HCT** *	**Sprout IX HCT** *	**NLV-I**	**NLV-II**
Fund Size:	**$15M Fund**	**$95M Fund**	**$147M Fund**	**$690M Fund**	**$310M Fund**	**$450M Fund**
Paid-In Capital	**$15M**	**$95M**	**$147M**	**$690M**	**$303M**	**$407M**
Vintage Year:	**(1993 - 2007)**	**(1995 - 2011)**	**(1998 - 2012)**	**(2000)**	**(2005)**	**(2008)**
First Investment	1995	1995	1998	2000	2005	2008
Gross Fund Returns						
Total Multiple [N]	4.4x	2.6x	1.7x	2.0x	2.1x	1.8x
Realized Multiple [N]	4.4x	2.6x	1.7x	2.2x	1.7x	2.0x
Total IRR [D]	44%	19%	10%	15%	19%	30%
Realized IRR [D]	44%	19%	10%	17%	23%	33%
Net Fund Returns						
Net Total Multiple [N]	3.69x *	2.17x *	1.49x *	1.66x *	1.75x	1.45x
Net Total IRR [D]	28.9% *	12.0% *	6.0% *	9.3% *	12.0%	16.7%
Net Distributed / Paid-In Multiple [F]	**3.69x** *	**2.17x** *	**1.49x** *	**1.55x** *	**0.51x**	**0.50x**
Net Distributed $s to LPs	*$56.3*	*$207.0*	*$218.7*	*$1,071.5*	*$154.7*	*$204.2*
Interim Fund Liquidity Metrics						
(Distributed + Public) / Paid-In Multiple [G]	--	--	--	1.62x	0.74x	1.18x
(Distributed + Liquid Public) / Paid-In Multiple [H]	--	--	--	1.58x	0.57x	0.75x
IRR Outperformance Versus Public Indices **						
PME+ (Basis Points over S&P 500 Healthcare Sector)	+2,064 bps	+302 bps	+441 bps	+776 bps	+201 bps	-187 bps
PME+ (Basis Points over S&P 500) **	+2,258 bps	+568 bps	+587 bps	+638 bps	+496 bps	+275 bps
PME+ (Basis Points over Russell 3000) **	+2,215 bps	+554 bps	+502 bps	+565 bps	+446 bps	+218 bps
PME+ (Basis Points over Nasdaq Composite) **	+2,125 bps	+554 bps	+725 bps	+451 bps	+181 bps	-21 bps

NLV and Sprout fund data as of March 31, 2014. Sprout fund statistics computed based on healthcare portfolio within Sprout.

* See Appendix 2 and endnotes A and E in Appendix 4. Based on synthetic funds with assumptions around recycling and fee structure.

** Based on Public Market Equivalent (PME+) methodology. See Appendix 3 and endnotes A, B, E and G in Appendix 4.

Please Section XIII: "Appendices" for definitions of terms and/or methodology.

INVESTMENT PERFORMANCE BY SECTOR

BIOPHARMACEUTICAL RETURNS SUMMARY:

The New Leaf team's biopharmaceutical investment performance has been strong in all funds. In aggregate, the New Leaf team has invested $945 million in 64 biopharmaceutical investments, and the historic realized biopharmaceutical results are **2.29x** gross realized cash-on-cash return ("***Multiple***") and a **21.4%** gross realized IRR. These realized returns have been driven by successful early and later stage investments. Table 1 summarizes the gross realized and unrealized returns from biopharmaceutical investments in each New Leaf fund and the Sprout Funds.

Table 1: Gross Biopharmaceutical Performance by Fund Group

$ amounts in millions, as of March 31, 2014

			Gross Value			Gross Multiple		Gross IRR	
	Deals	Total Cost	Total	Realized	Unrealized	Realized	Overall	Realized	Overall
New Leaf Ventures II, L.P. (2008)	20	$209.0	$508.5	$218.0	$290.4	2.59x	2.43x	67.5%	58.3%
New Leaf Ventures I, L.P. (2005)	14	$205.6	$501.6	$167.3	$334.4	1.68x	2.44x	22.8%	23.5%
All Sprout Funds (1993, 1995, 1998, 2000)	30	$533.5	$1,217.0	$1,163.9	$53.1	2.37x	2.28x	20.6%	20.0%
Total	**64**	**$948.2**	**$2,227.1**	**$1,549.2**	**$677.9**	**2.29x**	**2.35x**	**21.4%**	**21.6%**

Please see the endnotes in Appendix 4 for definitions of terms and/or methodology. Note that these gross returns are for portions of each fund, broken out by investment sector subfocus. Management fees, the general partner's carried interest and other expenses are applied on a fund level and not based on individual investments or a portion of the investment portfolio. For net returns on each fund which would include these items, please see Appendix 2.

INFORMATION CONVERGENCE RETURNS SUMMARY:

While New Leaf restarted new investment activity in information convergence opportunities in NLV-II, the Fund Managers already had an established track record in this sector from 9 investments in the Sprout Funds. In total, the Fund Managers have made 17 investments in this sector, for a combined total of $142 million of invested capital. The team has realized or partially realized nine investments for combined gross realizations of $262 million and a **2.62x** gross realized Multiple and **18.8%** gross realized IRR. Table 2 summarizes the gross realized and unrealized returns from information convergence investments in each New Leaf fund and the Sprout Funds:

Table 2: Gross Information Convergence Performance by Fund Group

$ amounts in millions, as of March 31, 2014

			Gross Value			Gross Multiple		Gross IRR	
	Deals	Total Cost	Total	Realized	Unrealized	Realized	Overall	Realized	Overall
New Leaf Ventures II, L.P. (2008)	8	$46.0	$59.0	$12.5	$46.5	3.44x	1.28x	95.5%	16.0%
New Leaf Ventures I, L.P. (2005)	0	$0.0	$0.0	$0.0	$0.0	N/A	N/A	N/A	N/A
All Sprout Funds (1993, 1995, 1998, 2000)	9	$96.2	$249.2	$249.2	$0.0	2.59x	2.59x	18.6%	18.6%
Total	**17**	**$142.1**	**$308.2**	**$261.7**	**$46.5**	**2.62x**	**2.17x**	**18.8%**	**18.5%**

Please see the endnotes in Appendix 4 for definitions of terms and/or methodology. Note that these gross returns are for portions of each fund, broken out by investment sector subfocus. Management fees, the general partner's carried interest and other expenses are applied on a fund level and not based on individual investments or a portion of the investment portfolio. For net returns on each fund which would include these items, please see Appendix 2.

MEDICAL DEVICES RETURNS SUMMARY:

The Fund Managers have been an active investor in the medical device sector across the New Leaf and Sprout Funds. Combined, the Fund Managers have invested $371 million in 29 medical device companies, and have gross realizations of $394 million and a **1.82x** gross realized Multiple and **9.4%** gross realized IRR. Table 3 summarizes the gross realized and unrealized returns from medical device investments in each New Leaf fund and the Sprout Funds:

Table 3: Gross Medical Device Performance by Fund Group
$ amounts in millions, as of March 31, 2014

			Gross Value			Gross Multiple		Gross IRR	
	Deals	Total Cost	Total	Realized	Unrealized	Realized	Overall	Realized	Overall
New Leaf Ventures II, L.P. (2008)	5	$72.0	$52.5	$1.8	$50.6	0.11x	0.73x	N/A	-9.2%
New Leaf Ventures I, L.P. (2005)	6	$73.3	$146.4	$67.3	$79.2	5.64x	2.00x	58.8%	15.5%
All Sprout Funds (1993, 1995, 1998, 2000)	18	$225.2	$328.9	$325.1	$3.7	1.73x	1.46x	8.3%	6.1%
Total	**29**	**$370.5**	**$527.8**	**$394.2**	**$133.5**	**1.82x**	**1.42x**	**9.4%**	**6.6%**

Please see the endnotes in Appendix 4 for definitions of terms and/or methodology. Note that these gross returns are for portions of each fund, broken out by investment sector subfocus. Management fees, the general partner's carried interest and other expenses are applied on a fund level and not based on individual investments or a portion of the investment portfolio. For net returns on each fund which would include these items, please see Appendix 2.

TOOLS, DIAGNOSTICS, & INFRASTRUCTURE RETURNS SUMMARY:

The Fund Managers have made investments in the tools, diagnostics, and infrastructure sector across the New Leaf and Sprout Group funds. The strategy has included predominantly later/commercial stage tools and infrastructure investments and a mix of early/development stage and later/commercial stage diagnostics companies over time. Combined, the Fund Managers have invested in 17 companies, for a total $221 million in cost. The Fund Managers have generated gross realizations of $261 million, for a **1.50x** gross realized Multiple and **14.2%** gross realized IRR. Table 4 summarizes the gross realized and unrealized returns from tools, diagnostics, and infrastructure investments in each New Leaf fund and the Sprout Funds:

Table 4: Gross Tools, Diagnostics, & Infrastructure Performance by Fund Group
$ amounts in millions, as of March 31, 2014

			Gross Value			Gross Multiple		Gross IRR	
	Deals	Total Cost	Total	Realized	Unrealized	Realized	Overall	Realized	Overall
New Leaf Ventures II, L.P. (2008)	3	$31.0	$36.1	$0.0	$36.1	0.00x	1.16x	N/A	4.8%
New Leaf Ventures I, L.P. (2005)	2	$25.7	$1.7	$1.7	$0.0	0.06x	0.06x	N/A	N/A
All Sprout Funds (1993, 1995, 1998, 2000)	12	$164.0	$273.1	$258.8	$14.3	1.88x	1.67x	16.4%	13.9%
Total	**17**	**$220.7**	**$310.9**	**$260.5**	**$50.4**	**1.50x**	**1.41x**	**14.2%**	**11.9%**

Please see the endnotes in Appendix 4 for definitions of terms and/or methodology. Note that these gross returns are for portions of each fund, broken out by investment sector subfocus. Management fees, the general partner's carried interest and other expenses are applied on a fund level and not based on individual investments or a portion of the investment portfolio. For net returns on each fund which would include these items, please see Appendix 2.

For further detail on prior performance, please refer to the Appendices and endnotes hereto.

IV. OPPORTUNITY IN THE HEALTHCARE SECTOR

The Fund Managers believe a number of macro market factors have aligned to create attractive and lasting conditions for NLV-III's targeted investment strategy in healthcare technology. Each of these market factors individually would have a direct positive impact on the level of risk and the potential for returns from investments in the healthcare technology sector. The fact that there are positive trends in all of them occurring simultaneously is unprecedented, and the Fund Managers expect that this will create a uniquely positive environment for NLV-III's investments in the healthcare technology sector. These macro market factors include the following:

STRONG GROWTH IN GLOBAL HEALTHCARE MARKETS

Healthcare is one of the largest and most dynamic segments of the global economy, and its growth is projected to continue the well-established historical trend of outpacing GDP growth in major economies for at least the next decade.[21] In the U.S., since 1970, health care spending per capita has grown at an average annual rate of 8.2% or 2.4 percentage points faster than nominal GDP. The persistence of this trend suggests systematic differences between health care and other economic sectors where growth rates are typically more in line with the overall economy. A smaller difference is projected over the 2011 to 2020 period, where the average annual growth in per capita health spending (5.3%) is projected to be about 140 basis points higher than the growth in GDP (3.9%)[22]. This powerful and sustained growth differentiates healthcare from many other large industrial and technology sectors, and it creates a positive backdrop for investment in certain areas within the sector.

The drivers of healthcare market growth vary between mature and emerging economies, but in both cases the shifts are resulting in significant increases in per capita health care consumption and predictable increases in spending to meet the rising demand. In developed economies, growth is being driven primarily by an aging population coupled with a continued willingness of payers to cover the costs for new therapeutics and interventions that meaningfully extend or improve the quality of patients' lives. In the U.S., which is representative of the demographic shifts in other major economies, the number of people over 65 is expected to double over the next three decades, reaching 70 million by 2030 or roughly 20% of the total U.S. population.[23] This aging demographic has a higher prevalence of disease and the cost of delivering care to treat the diseases of this older demographic is rising steadily. For example, in 2009, the per capita health care cost for a person 65 – 74 years old was approximately $14,000, but it was more than double that ($33,000) for those over 85. Before the end of this decade, the projected per capita annual cost to care for these same two groups is expected to rise to $22,000 (+57%) for 65 – 74 year olds and $55,000 (+67%) for those 85+[24].

Emerging markets such as Brazil, Russia, India and China (BRICs) are also contributing to the growth in health care spending globally, as these emerging markets mature and begin moving towards the standards of their counterparts in developed economies. The size of the middle and upper classes in these countries is growing rapidly, and the spending power of these groups is becoming important to the global economy in many sectors. As the populations of these countries become more affluent, a greater proportion of their GDP is being spent on health care, and this is leading to rapid growth in many different healthcare product sectors in these countries. For example, China's prescription drug market, which is projected to be the world's second largest by 2020, is projected to grow to more than $110 billion by 2015 – up from $50 billion in 2010.[25] The medical device market in China is showing a similar growth pattern, with the current $17 billion medtech market (world's fourth largest) projected to more than double within the next five years.[26] This growth in emerging economies is expected to continue for the foreseeable future, and as it does, it will open vast new markets for established healthcare products companies in more developed countries, and will become increasingly important as a percentage of sales of global brands. At the same time, it will create opportunities for smaller, U.S. based companies to partner with large multinationals and domestic companies in the BRICs that have established distribution channels in these markets.

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[21] CMS, OECD, Eurostat

[22] Historical data from Centers for Medicare and Medicaid Services, Office of the Actuary, National Health Statistics Group

[23] U.S. Census Bureau

[24] Alvarez & Marsal healthcare, getting much closer to the cost precipice

SIGNIFICANT OPPORTUNITY CREATED BY HEALTHCARE REFORM & RESTRUCTURING

As a result of the strong growth in healthcare expenditures, for at least the next decade, and likely much longer, the healthcare industry in the U.S. will be going through a period of significant reform and restructuring as the increasing healthcare costs place unsustainable fiscal burdens on government programs. After years of dire predictions and endless debate amongst elected officials, pundits, corporate leaders, and patient advocacy groups, there is recognition that long term healthcare liabilities are a critical issue and require broad reform to control their growth before they lead to irreparable fiscal harm. While much of the attention in these initiatives is focused on identifying opportunities to cut costs, the silver lining in them for investors is that their objectives also seek to improve the quality of healthcare and to substantially broaden the population that has access to healthcare services covered by third party payment.

In the U.S., the Federal Government has laid the foundations for restructuring the healthcare system through two key pieces of legislation. First, the HITECH Act provides large government subsidies for the adoption of IT tools by healthcare providers. The Federal Government has recognized that a fundamental underpinning of healthcare reform is a massive upgrade of the information technology infrastructure at all levels of the industry, and through this legislation has earmarked $26 billion dollars in direct subsidies to catalyze investment in this area.

The second key piece of legislation is the ACA, which is being implemented as a first step in the overhaul of the U.S. healthcare system. The ACA was signed into law in the U.S. in 2010 and begins its implementation phase in 2014. It is a complex piece of legislation that is designed to reform and overhaul many aspects of the U.S. healthcare system. The goals of the ACA are to increase the affordability and rate of health insurance coverage for all Americans, and to control the runaway growth in costs of health care faced by government, employers, and individuals. The ACA mandates a number of broad reaching mechanisms to achieve these goals, and introduces a range of new incentives/penalties that force market participants to address major cost, efficiency, and quality issues within the healthcare system.

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[25] Reuters

[26] InVivo (Elseveir), June 2013

The ACA and other healthcare reform initiatives are challenged by dual and somewhat conflicting objectives. They are focused on reducing costs and slowing growth rates in spending, but at the same time expand the size of the population that has access to healthcare covered by third party payment mechanisms. In order to cover the increased costs of the expanded coverage, reform initiatives attempt to radically improve the efficiency of healthcare delivery as a way of freeing up resources that can be redirected to providing care to populations that had previously not been covered. Some of the lowest hanging fruit that is being targeted in early reform initiatives is eliminating waste from the healthcare system. There are enormous resources that can be freed up by eliminating expenditures that are unnecessary or duplicative. In the U.S. healthcare system alone, there is an estimated $765 billion that is wasted annually. More than half of that total ($415 billion) is the result of fraud, unnecessary services, and inefficiently or mistakenly delivered care. Another 25%+ of the total ($190 billion) is the result of excess administrative costs (e.g., inefficiencies associated with paperwork and documentation)[27]. Finding ways to reduce waste in the system offers the opportunity to create significant value, but requires the adoption of entirely new tools and technologies by payers, providers, and patients. Developing these tools, applications, and systems is an area of significant opportunity for innovative technology focused companies.

A major part of eliminating waste in healthcare will be accomplished by driving efficiency and deriving maximum benefit from the enormous levels of current expenditures. Achieving this goal will have to include a fundamental change in focus to the principles of value-based medicine across all levels of the healthcare system. This is a radical change in objectives that is already happening, and it is leading to entirely new reimbursement models built around paying for technologies and treatments that provide care efficiently and at a cost proportional to the health benefit they deliver. Value-based medicine focuses on outcomes from healthcare services, which more closely aligns the interests of the payers with the healthcare providers and product companies whose services and products are the major cost elements in the delivery of healthcare. Although simple conceptually, this is a fundamental change in how healthcare is paid for from the historical reimbursement models that have focused on fixed payments for delivery of discrete procedures, with no corresponding emphasis on quality of the care delivered or on the resulting patient outcomes.

Refocusing treatment objectives within the healthcare system towards high quality outcomes over numbers of procedures will require many healthcare companies to reengineer aspects of their business models, but it will also provide them with new opportunity. In a system that rewards outcomes, companies and organizations that run with the highest quality and most efficiently will have significant opportunity to expand their own returns by taking on risk in the treatment of patients. Opening the market to this dynamic, where there is opportunity to earn a return on cost-effective, high quality patient management and outcomes, will stimulate the development and adoption of an entirely new set of enabling technologies and business models, which represent opportunity for innovative, technology-based, development and growth stage companies.

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[27] National Academy of Sciences, "Best Care at Lower Cost: The Path to Continuously Learning Health Care in America"

There is no question that the shift to value-based reimbursement models will have a major impact on the economics of healthcare. Payers will be looking for ways to significantly reduce costs in all areas where a range of viable lower cost solutions are available, and will force providers to use those wherever possible through increasingly restrictive reimbursement policies. As an example, one area where this type of change has been implemented successfully for years is in the increased use of generic drugs, where payers no longer offer unrestricted reimbursement for the use of high cost, premium priced branded biopharmaceutical products that deliver only minor benefits in terms of convenience, or slight improvements in efficacy to small percentages of patients. This type of value-based review is now going on in all areas within healthcare, and is resulting in changes that are having a major impact on what services and products are selected, and who bears what percentage of the cost of that selection.

At the same time that payers and other 'at-risk' organizations are looking for any and all opportunities to move to lower cost alternatives, they are also continuing to invest in the adoption of innovative new therapeutics which can both improve outcomes and deliver quantifiable value, even when considering their additional costs and premium pricing. The products that receive this type of support from payers are ones that are focused on addressing truly unmet medical needs and deliver significant efficacy or safety benefits to patients, when compared to existing standards of care. They are also usually based on new technologies that enable novel approaches to the treatment of diseases and disorders. There are vast areas in medicine where large unmet medical needs exist and where scientific and technological progress is enabling entirely new approaches to addressing these. Where these intersect are areas of great opportunity for experienced investors.

RAPID ACCELERATION IN INNOVATION IN TARGETED SECTORS

Biopharmaceuticals:

Decades of government and industry investment in the study of the biological and genetic basis of disease is translating into a steady stream of new products with improved efficacy and decreased toxicity, and these are transforming how many high-morbidity diseases can be treated. Through this growing body of work, a much deeper understanding of the biochemical pathways underlying complex diseases is emerging, which is leading to identification of many new molecular targets for drug therapy. This targeted approach to pharmaceutical R&D is a fundamental change from the historical process that relied on large-scale, random screening of drug candidates for activity. A whole new generation of products targeting diseases at the molecular level is emerging and these offer much higher levels of efficacy and improved safety to specific groups of patients whose disease is well characterized by biomarkers that are tightly linked to the mechanisms of the underlying disease. This more targeted approach to discovery and development offers important benefits to all constituents, which ultimately improves the investment environment in biopharmaceuticals.

Oncology (i.e., cancer) is one therapeutic area where some of the most significant progress has been made recently. Targeted therapies in certain indications in oncology now provide for more effective treatments with fewer side effects than one-size-fits-all chemotherapy drugs. For example, new therapies have recently been developed that target specific subsets of malignancy through molecular targets including EGFR, HER2, and BRAF that have led to dramatic improvement in the treatment of certain cancers (e.g., lung, pancreatic, colon, breast, melanoma, and several hematologic cancers). It is expected that the next wave of advances will transform these diseases further from what has historically been a death sentence into a chronic, treatable condition. As this happens, huge markets will be created for entirely new biopharmaceutical products. While cancer is the leading disease area, this pace of dramatic scientific and technological progress is extending into several other areas of medicine and will likely accelerate. Many of the initial examples of targeted or personalized therapies in non-cancer indications have been in rare or so called "orphan" diseases following discovery of the underlying genetic abnormalities. This period of rapid technology advancement establishes a cycle of innovation in the market that creates great opportunity for highly focused, small, companies.

Information Convergence:

The rate of innovation in information convergence has already accelerated relative to the historical rate of innovation in healthcare information technology (“HCIT”) due to several underlying factors. First, as mentioned, the HITECH Act provided billions in direct incentives to encourage healthcare providers to adopt information technology, beginning with electronic medical record (“EMR”) systems. This led to a significant increase in spending on EMRs which benefitted large established EMR vendors, but it also benefitted new smaller players in the EMR market. Importantly, the broad upgrade of information technology and deployment of EMRs across the healthcare provider market has established a technology infrastructure in the market that benefits an entirely new generation of companies that are developing technologies that layer onto existing EMRs and address the next levels of IT adoption. This next level of information technology adoption is dictated by the HITECH Act through a series of “meaningful use” incentive initiatives.

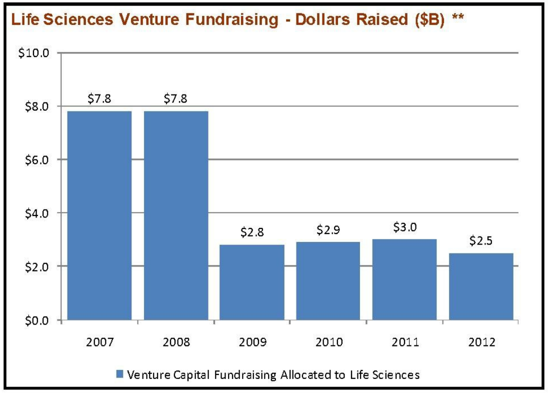
Another key factor that has led to an acceleration in innovation in information convergence is that most of the highest value innovation in this sector is arising from integrating technologies that have been discovered, developed, validated, and implemented in completely different sectors (e.g., cloud storage, mobile computing, wireless communications, web-delivered software, diagnostics and sensors). These product development efforts draw heavily from existing technologies and allow small companies focused on addressing discrete problems and opportunities within the healthcare market to develop and launch products with minimal technology discovery. The bulk of the effort in these activities is in rapidly creating high value products by combining well-understood and available technologies, and getting them into the hands of customers to evaluate their performance in real world use conditions. This early customer experience allows companies to generate revenues early in their life, but also provides valuable user feedback which can be used to continuously improve product design elements. The benefit of this type of product development effort in the information convergence sector is that it reduces risk, lowers capital requirements, and results in more predictable timelines.

Considering the size of the opportunity and the large number of discrete problems and inefficiencies that must be addressed, the Fund Managers expect the next decade will be a period of robust innovation and company creation. Smaller companies are likely to thrive during this period as they are better able to quickly move from opportunity to product launch.

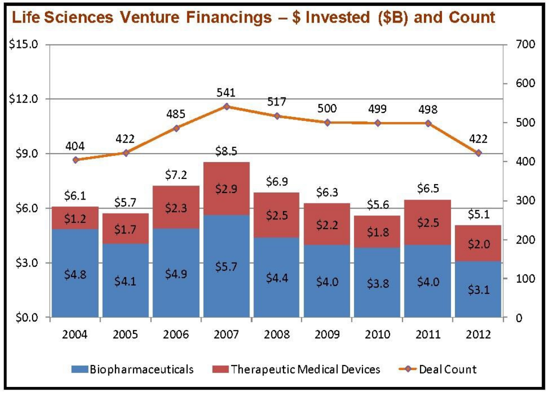
CONTRACTION IN HEALTHCARE VENTURE CAPITAL INDUSTRY & CAPITAL MARKET DYNAMICS MORE BROADLY CREATE OPPORTUNITY IN DEVELOPMENT STAGE AND EARLY COMMERCIAL STAGE COMPANIES

For the last several decades the healthcare venture capital industry has been the predominant source of early and growth stage funding for smaller, technology focused companies while they pursue product development, regulatory approval, and early commercialization. Over the last several years, there has been a significant contraction in the size of the healthcare venture capital industry in terms of amount of capital available to fund new companies, and the number of active firms investing in new companies. This contraction creates significant opportunity for those funds that remain active, as fewer firms and less capital is translating into less competition for deals. The Fund Managers have benefited from the reduced level of competition during the new investment period for NLV–II, and they believe these conditions will remain in place for at least part of the new investment period of NLV-III. It is too soon to know for sure, but it is likely the industry may have already reached the bottom of this cycle of contraction and could see a re-set that begins to shift the industry to more normalized conditions due to the recent stronger IPO and M&A markets.

Life Sciences Venture Fundraising



Investments into Biopharma and Medical Devices

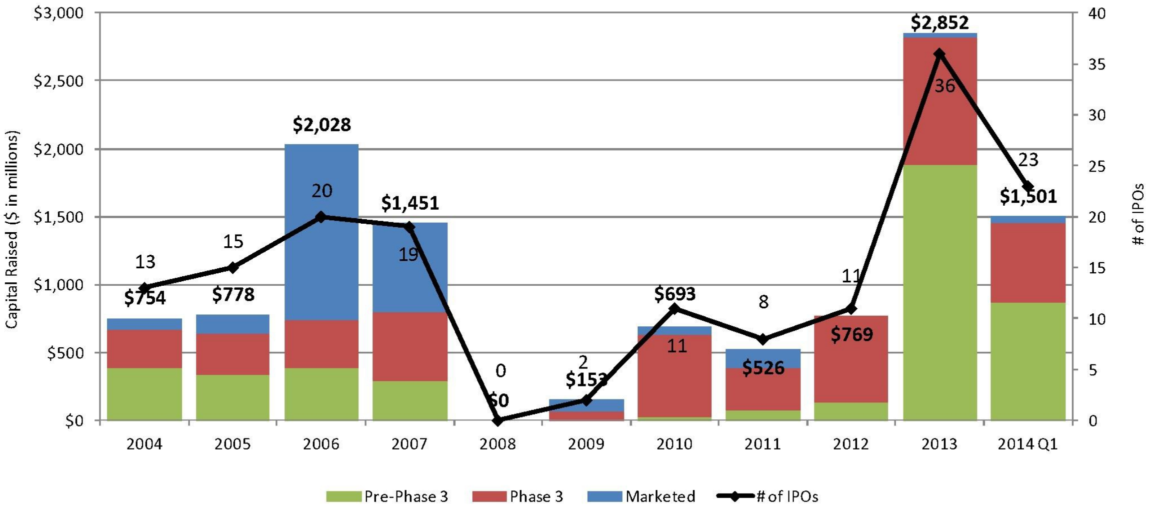


Source: Venture investments data from VentureSource (U.S. only). Includes therapeutic medical devices only.
** "Life Sciences Venture Fundraising data from Dow Jones; Fenwick & West Analysis in 2012 Trends in Terms of Life Science Venture Financings

The market for IPOs was strong during 2013 and the first quarter of 2014 for companies with compelling stories based on differentiated technology, targeting important unmet medical needs, large market opportunities, and experienced management teams. Although the number of IPOs in the healthcare technology sector increased significantly, most of that activity was driven by offerings for biopharmaceuticals companies. The significant increase in IPO activity was driven by a number of factors, but one that had an important impact is the Jumpstart Our Business Startups Act (JOBS Act). This legislation was signed into law in the U.S. in April, 2012 and it changed the regulations governing how certain private companies can interact with investors in advance of an IPO. Under the new regulations, emerging growth companies can file their IPO draft registration statement privately with the SEC, and continue to meet with interested investors over several weeks or months to explain clearly their company strategy and technology in "testing the waters" meetings. The Fund Managers believe these new regulations are especially helpful to private biopharmaceutical companies, as they allow interested investors to grasp the complexities and opportunities of the small biotech companies before the formal filing of their IPO registration statements, and the start of the traditional IPO road show. The Fund Managers believe the JOBS Act and the use of "testing the waters meetings" has been one of the factors that helped open the current biotech IPO window, expanded the base of investors (public market specialist and generalist investors) participating in the recent offerings, and helped drive the after-market performance of many of these offerings.

Biopharma IPO Trends

($ in millions)



The combination of all of these positive factors has significantly strengthened the position of smaller development and early commercial stage healthcare technology companies, and creates a unique period of opportunity for investors in the sector.

V. NEW LEAF VENTURE PARTNERS INVESTMENT STRATEGY

New Leaf's investment strategy is differentiated in the venture capital industry in terms of its sector focus, specific approaches within each sector, and the depth of experience and long-term track record that supports each element of the strategy. NLV-III will be invested in a diversified portfolio across four sectors: a primary focus on **Biopharmaceuticals** and **Information Convergence**, and a secondary focus on **Medical Devices** and **Biological Research Tools & Infrastructure**. The Fund Managers believe that these are the sectors within the healthcare technology industry where, with a targeted and specific sector strategy, there is the potential to generate attractive returns within a time frame consistent with the goals of investors in a venture capital fund. Importantly, the drivers behind the opportunity for value creation, major risk factors, capital requirements, timelines, and universe of potential acquirers in each of these sectors are distinct, and thus a portfolio constructed with investments with a combination of these will benefit from this diversification.

The Fund Managers will invest the Fund in a diversified portfolio composed of an estimated 24 – 28 companies that will be predominantly domiciled in the U.S., but could include a small number of companies based in Western Europe or Canada. The Fund Managers intend to serve on the boards of directors for the majority of the companies in the portfolio and will generally seek to establish ownership positions in companies that are large enough to allow them to exert considerable influence on the company's strategies, budgets, financing plans, operating objectives, management team composition, and paths to exit.

Consistent with past transitions between funds, the Fund Managers have evolved the investment strategy for NLV-III to reflect the team's view of where the most attractive opportunities will exist during the life of the Fund. The investment strategy for NLV-III will be distinct from other recent funds in terms of the specific weightings that will be placed on the targeted sectors, and certain considerations for company selection within those sectors.

BIOPHARMACEUTICALS INVESTMENT STRATEGY

As in all previous funds, biopharmaceutical investments will be the core focus for NLV-III and will comprise approximately 50% - 60% of the Fund. The Fund's biopharmaceutical investments will be mostly in development stage and commercial stage private companies, and will also likely include some investments in small capitalization public companies through structured transactions. The Fund Managers intend to construct a well-diversified portfolio of biopharmaceutical investments that includes a balanced mix of companies with earlier stage and later stage development programs and product platform technologies. Regardless of stage, by focusing on biopharmaceutical investments ahead of key risk inflection points, the Fund Managers expect to fund companies through the periods of greatest value creation to points where they will either become attractive targets for acquisition or partnership, or become of high interest to public market investors. In some cases, private companies whose underlying assets mature to these stages will become viable candidates for initial public offerings (IPOs) or mergers into public companies.

Focus: Private and public companies with novel product programs & product platforms
Investments in the biopharmaceutical sector within NLV-III will target companies that are developing products that address clinically important unmet medical needs with competitively differentiated technologies. The Fund will invest across all stages, usually in companies that fit one of two different profiles. The first is companies with clearly differentiated, clinical stage **proprietary product programs** focused on significant market opportunities, where value can be built around a product(s) by financing it through one or more stages of clinical development, and in some cases to regulatory approval and commercialization. The second are companies with **novel product platforms** that are at or near the clinical stage with a lead product(s). These companies build value around both the product(s) itself as it advances through clinical development and around the product platform as its utility as a product creation engine is validated through the progress of the lead product(s).

The Fund Managers expect to identify investment opportunities within private or public companies whose primary asset(s) fall within one of the following categories:

- Early and mid-clinical stage product programs targeting a well validated mechanism of action in a disease with significant unmet medical need. The therapeutic areas and specific mechanisms of action will be known to be of high strategic interest to a number of larger biopharmaceutical companies. The target product profiles of the therapeutic product(s) for these assets will have clear points of competitive differentiation around efficacy and/or safety versus available therapeutics (and known clinical stage programs), and the clinical development programs behind them will be designed to provide clear data in support of these. Examples of these types of biopharmaceutical investments in the NLV portfolio are **Array Biopharma** (NLV-II, NASDAQ: ARRY, oncology, exited at 2.25x), **Chimerix** (NLV-II, private initially, now public on NASDAQ: CMRX, novel anti-viral therapy), and **Versartis** (NLV-II, private, novel, long-acting human growth hormone).

- Novel product platforms that offer the potential to target known, and well understood pharmacologic mechanisms of action in entirely new ways, or a product platform that has the potential to open up a field of entirely new pharmacologic mechanisms in diseases with large unmet medical need and rapidly advancing understanding of the underlying biology (e.g., hematologic and solid tumors). These platforms will be supported by validating data that provide strong support for the underlying biological hypotheses, and the companies will be at or approaching the clinical stage with an owned or partnered lead product program. The product platforms will usually have strong evidence of strategic interest from large or mid-sized biopharmaceutical companies through one or more partnerships that have generated non-dilutive capital for the company. Examples of three novel product platform companies in the NLV portfolio are **Pearl Therapeutics** (NLV-I, private, pulmonology, exited at 2.5x plus milestones), **Epizyme** (NLV-II, NASDAQ: EPZM, oncology, exited at 2.0x), and **Principia** (NLV-II, private, immunology & oncology).

- Later development stage and commercial stage, biopharmaceutical investments, where the investment theses will be to create value by funding companies through Phase 3 clinical trials, regulatory approval, and into early commercialization. In some cases, the

Fund will seek to fund companies much later into commercialization to the point of sustainable profitability. These investments will be into private or small capitalization public companies in situations where the Fund Managers believe that the key risk inflection and the period of greatest value creation will be around regulatory approval and demonstration of commercial attractiveness of the product. These investments will focus on products where the level of clinical and regulatory risk is relatively low, and where commercial penetration can be driven by smaller, highly targeted sales and marketing activities. Biopharmaceutical companies at this stage have historically been attractive acquisition targets, and have consistently demonstrated that they can access public markets through IPOs in a broad range of market conditions. Examples of this type of later stage investment in the New Leaf portfolio include **Acadia Pharmaceuticals** (NLV-II, NASDAQ: ACAD, exited at 2.5x), Phase III, focused on psychosis associated with neurodegenerative diseases**,** **Durata Therapeutics** (NLV-II, private initially, now public on NASDAQ: DRTX), Phase III, focused on a late stage antibiotic development program spun out of Pfizer, and **InterCept Pharmaceuticals** (NLV-II, NASDAQ: ICPT, exited at 3.2x), Phase III, focused on an orphan indication in liver disease.

- Investments in public companies at any stage, whose primary assets are product programs or product platforms. Most of these investments will be focused on small capitalization companies at the clinical or early commercialization stage. New Leaf's focus on investment opportunities in small capitalization public biotech companies leverage the broad investment capabilities within the firm and benefit from the focused efforts of a small team of investment professionals dedicated exclusively to public market activities. As a result of this integrated approach, investments in public companies often target companies the Fund Managers have tracked over a number of years, some from the time when they were private companies. The dedicated public market team proactively tracks and screens the aggregate universe of biotech companies, with the goal of identifying compelling risk/reward investment opportunities. The primary focus of the screening efforts is to identify high-quality companies with attractive valuations that require financing to fund the company through key development milestones. The Fund will generally look to source or augment transformative, structured transactions in public companies, where a New Leaf partner will have the opportunity to join the board of directors. An example of an investment that resulted from New Leaf's focus on public market opportunities includes **MEI Pharma** (NLV-II, NASDAQ: MEIP), an investment the Fund Managers made to recapitalize the company after it had acquired a lead asset, Pracinostat, and needed capital to advance the program through clinical development. Pracinostat was an asset that was well known to New Leaf, as members of the team had followed it closely for several years while it was owned by a private company (S*Bio), and had made attempts to acquire and spin out the asset in the past. In addition to sourcing opportunities, the public market team assists the broader biopharmaceutical investment efforts by managing the sale and exit of New Leaf's larger positions in public securities, and by providing real-time insight into evolving market sentiment to the biotechnology and broader healthcare technology sectors that helps guide decisions around new investments and exit decisions.

For a complete list of investments made by the Fund Managers in healthcare technology companies see Appendices 1 and 4 .

Leadership: NLV are leaders in biopharmaceutical investing across all stages and transaction types

The New Leaf team is well positioned to continue to play a leadership role in the sector. Over the last two decades, the Fund Managers have demonstrated an ability to access high quality biopharmaceutical investments at all stages, by sourcing opportunities through a range of activities that result in differentiated and in many cases proprietary deal flow. Deal flow is generated by relying on New Leaf's extensive network of relationships that span senior executives in the pharmaceutical and biotech companies, top scientists at world-class academic institutions, and leading investors in the venture capital, private equity, and small cap public sectors. By leveraging this network the Fund Managers gain visibility to interesting investment ideas, and develop insight into the long term strategic interests of the larger pharmaceutical and biotech companies and the evolving attitudes about value and risk of public market investors. Through this continuous process the Fund Managers seek to ensure that they are able to view the widest range of high quality opportunities and have a highly informed and discerning screen to determine which of the opportunities have the greatest long term investment potential. It is these efforts that have allowed the New Leaf team to create some of the best performing portfolios of biopharmaceutical investments in the industry in the Sprout Funds and in NLV-I and NLV-II, and has resulted in successful and consistent track records of returns in the sector. The Fund Managers have demonstrated leadership in the sector over the long term through transactions that span the full range of stages and transaction types, including:

- **Start-Ups**: The Fund Managers have played important roles and have been founding investors in a number of successful start-up companies. These have included **Pearl Therapeutics** (NLV-I, exited in sale to Astra Zeneca, 2.5x multiple plus milestones), **Relypsa** (NLV-I, private initially, now public on NASDAQ: RLYP), **Convergence/Calchan Pharmaceuticals** (NLV-II, one start up that subsequently split to become 2 separate companies), **Durata Therapeutics** (NLV-II: IPO – July, 2012, NASDAQ: DRTX), and **Ilypsa** (Sprout IX, exited in sale to Amgen, 6.9x multiple).

- **Established Private Companies**: The New Leaf Team has played the role of lead investor in a large number of private investments. These have included **Cerexa** (NLV-I, exited in sale to Forest Labs, 5.4x multiple), **Stromedix** (NLV-I, exited in sale to Biogen Idec, 1.8x multiple plus milestones), **Chimerix** (NLV-II, IPO – April, 2013, NASDAQ: CMRX), and **Auxilium** (Sprout IX, NASDAQ: AUXL, exited at 4.6x).

- **Restructuring Private Companies**: The Fund Managers have led financings that have restructured private companies, providing capital to fund business plans that have refocused company's business plans on certain key assets and product development programs and significantly reducing or terminating investments into others. Examples of this type of investment include **Intarcia Therapeutics** (NLV-I) and **Synageva Biopharma** (NLV-II, reverse merger to become public – November, 2011, NASDAQ: GEVA; exited at 7.3x).

- **Restructuring & Recapitalizing Public Companies**: The New Leaf team has created interesting investment opportunities through restructuring and recapitalizing public companies. Examples include **MEI Pharma** (NLV-II, NASDAQ: MEIP) and **Sirna**

Therapeutics (Sprout IX, formerly NASDAQ: RNAI, exited through sale to Merck, 8.1x multiple).

- Structured Investments in Public Companies: The Fund Managers have led and participated in a number of structured investments into small cap public companies. These have included **Array Pharmaceuticals** (NLV-II, NASDAQ: ARRY; led a structured follow-on investment, NLV team member joined the board, exited at 2.25x), **Acadia Pharmaceuticals** (NLV-II, NASDAQ: ACAD, exited at 2.5x) and **Intercept Pharmaceuticals** (NLV-II, NASDAQ: ICPT; anchored company's IPO, NLV team member initially joined the company's board, exited at 3.2x).

For a complete list of investments made by the Fund Managers in healthcare technology companies see Appendix 1.

Favorable conditions for biopharmaceutical investments for NLV-III
The Fund Managers believe that NLV-III will be invested in a market with attractive conditions for investment in the biopharmaceutical sector. As a result, the Fund should have the opportunity to invest in compelling biopharmaceutical opportunities that have attractive risk-return profiles. A number of factors support this positive view of the investment thesis in the biopharmaceuticals sector.

First, the Fund will invest in a portfolio of biopharmaceutical companies with an emphasis on those that are developing targeted therapeutic opportunities that address mechanisms of disease at the molecular level with high specificity and offer meaningful efficacy and safety benefits to specific sub-groups of patients. Where possible, the Fund will look to invest in companies with product programs that are guided by validated biomarkers that can enable highly specific patient selection and provide an objective measurement of drug effect. The Fund Managers believe that opportunities with these characteristics offer important benefits to all market participants in the biopharmaceuticals sector, and that these substantially de-risk the R&D and commercial sides of the biopharmaceutical business model in ways that can meaningfully benefit investors.

Patients are offered therapies that are more targeted to their disease, and benefit from improvements in efficacy and safety through increased life expectancy, improved quality of life, and a more rapid return to a fully productive life;

Physicians have access to an arsenal of products that they can choose from to tailor therapy to specific patients' disease, and avoid the costs and risks associated with using less effective therapies that carry all the safety risks, but may or may not have any effect on the specific disease subtype of an individual patient;

Payers may pay higher prices for these therapies, but with the enhanced efficacy and safety profile that's possible with biomarker based targeting, they can expect to see better overall patient outcomes, that ultimately save money within the system;

Pharmaceutical Companies benefit because with targeted approaches to drug discovery and development, the probabilities of success improve, interactions with regulators become less risky, timelines to move products from the lab to the market can be significantly shortened, and sales and marketing becomes more efficient as commercial campaigns only need to target those physicians seeing specific subsets of patients;

Regulatory Authorities evaluate the risk-benefit of new therapeutics on specific subgroups of patients that are known to be suffering from a specific sub-type of diseases, and can thus require fewer patients and shorter timelines in clinical programs, ultimately lowering the risks and costs of the approval pathway for developers of new therapeutics; and

Investors can expect to see improving returns as the risk/reward equation of drug development is shifted significantly as a result of shortened timelines, smaller clinical trials, improved probabilities of success, and reduced risks at the clinical, regulatory, and commercial levels.

Second, the biopharmaceuticals sector is an improving regulatory environment in the U.S., helping set the stage for a positive investment cycle. There is strong evidence that over the last decade the FDA has been working to improve the drug approval process in the U.S. in tangible ways that benefit biopharmaceutical companies and reduce the risk for their investors. Although the path to regulatory approval for product programs has not been made easy by any standard, the FDA has made strides in making the process more predictable and streamlined. Some of the most significant improvements have been in therapeutic areas where there is a high level of unmet medical need. For example, the U.S. Food and Drug Administration ("FDA") is demonstrating clear interest in working more constructively with industry to bring new safe and effective therapeutics to market that target diseases that have potentially large cost burdens on the healthcare system (e.g., oncology). Additionally, the FDA has also improved the way that they communicate and interact with sponsors of new products, by creating set administrative procedures and timelines that they are required to meet through legislation like the Prescription Drug User Fee Act ("PDUFA") and the FDA Modernization Act. The FDA has implemented other initiatives that attempt to clarify requirements and shorten regulatory timelines for certain types of therapeutic products that they view as highest priority. These initiatives include programs to grant special designations, including Breakthrough Therapy, Accelerated Approval, and Priority Review, which can cut significant time out of the standard approval process. The impact of these and other programs has become apparent in the number of new drug approvals ("NDAs") by FDA in both 2011 (30 NDAs) and 2012 (39 NDAs), which trended higher compared to the previous six years and versus historic averages.[28] Overall, these initiatives and others, both in the U.S. and in other markets (e.g., E.U. and Japan), have made the regulatory environment more favorable for investors in the biopharmaceutical sector, and have reduced some of the uncertainty in a critical part of drug development.

A third factor supporting the positive investment thesis in biopharmaceuticals is the interplay of favorable conditions in the capital markets and the strategic needs of the large and mid-sized companies in the sector. These dynamics should create a positive financing and exit environment for biopharmaceutical companies for the foreseeable future, and the Fund Manager expect them to contribute to improving venture returns. The aforementioned contraction in the number of active firms and capital flows into healthcare technology venture funds has significantly reduced the level of competition between firms. At the same time, large and mid-sized biopharmaceutical companies have become increasingly dependent on development stage companies as an important source of innovation and new products to supplement R&D pipelines and drive future growth. Strong growth potential is critical for these companies to support their valuation metrics, especially in light of expected patent expirations on their commercial products. In total, over $290 billion of revenue is at risk from patent expirations between now and 2018.[29] The large and mid-sized companies are addressing this strategic need to a large extent through increased acquisitions and partnerships with development stage companies that have maturing assets. The Fund Managers expect this dynamic to increase competition between the larger strategic players in the industry as they vie for the most interesting companies with maturing development stage assets. The development stage companies should have strong negotiating leverage in these deal discussions, which should drive premium valuations on acquisitions and attractive terms on partnerships.

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[28] Food and Drug Administration. Center For Drug Evaluation and Research

The increased strategic need for acquisitions and partnerships comes at a time when the large and many of the mid-sized companies in the industry are in a strong financial position to complete high value deals. The top ten pharmaceutical companies have a total of $140 billion in cash on their balance sheets today and have a combined market capitalization of over $1.3 trillion.[30] A relatively new set of well funded potential acquirers and/or partners has emerged over the last decade, as many of the mid-sized biotech companies have seen their commercial businesses thrive, and now have strong revenue and profit growth. Since 2002, the number of public biotech companies with annual profit (EBIT) over $100 million has doubled to 16, and the combined annual profit of these companies has increased 4.5 times to $16.6 billion.[31] This has significantly increased the number of companies in the industry with the financial wherewithal to complete large cash transactions. At the same time, the industry's R&D productivity has been disappointing in terms of new products generated by massive internal R&D budgets. To address the gaps created in their R&D pipelines, most large and mid-sized players have shifted a large percentage of their R&D budgets away from internal R&D projects and have increased investment in "externalizing" a large portion of their R&D. These companies have slashed internal R&D budgets, closed major R&D facilities, and made large cuts to headcount. It is estimated that the pharmaceutical industry cut R&D spending by 5.7% in the U.S. and 2.2% globally in 2012 alone,[32] and this trend has continued in 2013. Most large and mid-sized biopharmaceutical companies now have large internal groups that include a combination of business and scientific resources that are dedicated exclusively to external search and evaluation, and are tasked with finding opportunities for mergers, acquisitions, and partnerships that will bring in new technology. Some have taken this strategy even further and have set up their own internal venture capital investment groups with the belief that by co-investing with more experienced institutional venture investors they can improve their visibility into the latest innovations and improved access to the best opportunities. The Fund Managers believe that this combination of financial strength and strategic need to source more products than internal R&D efforts can produce will lead to a significant increase in deal activity, creating a strong exit environment for smaller development stage companies for the foreseeable future.

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[29] eValuatePharma

[30] Burrill Biotech 2012 Report

[31] New Leaf Analysis of public company financial data as provided by Bloomberg

[32] Battelle-R&D Magazine Annual Global R&D Funding Forecast

The Fund Managers expect this combination of positive market conditions to remain favorable for generating attractive returns in the biopharmaceutical sector for the foreseeable future. Although industry returns have been characterized by inconsistency and generally associated with long timelines, a small number of top investors have been able to consistently build portfolios that outperform the venture capital industry and relevant public market indices. There is no substitute for experience in this sector, and the New Leaf team brings one of the most powerful and proven combinations of team, strategy, and track record to investing in this dynamic sector, and is positioned well for continued success in NLV-III.

INFORMATION CONVERGENCE INVESTMENT STRATEGY

The Fund Managers believe that U.S. is rapidly approaching a fiscal crisis that will be driven largely by rising healthcare expenditures and the exponential increase in future healthcare liabilities. This looming threat is a major driver behind Information Convergence ("I.C."), the second of the two primary focus areas in NLV-III. Governments and the private sector alike are being forced to significantly increase the efficiency of the healthcare system, and consequently are beginning to invest heavily in technologies that reduce cost and improve the quality of care. New technology solutions are emerging from the intersection of a diverse, yet interconnected set of technologies that define Information Convergence, including cloud storage, mobile computing, wireless communications, web-delivered software, big data analytics, diagnostics and sensors.

I.C. companies are integrating these technologies in ways that more cost effectively prevent, diagnose, and treat disease. These applications and products can be highly valued by addressing costly inefficiencies within the healthcare system. The Fund Managers believe I.C. will play an enabling role in many of the initiatives that will form the core of healthcare reform, including the transformation of healthcare reimbursement models from volume to value-based, and that this will be a major area of opportunity for investors for the foreseeable future.

Within I.C. the Fund will seek opportunities that target some of the largest inefficiencies in the healthcare system. These include: (1) inefficiency in delivery of care and excess administrative costs; (2) unnecessary services and missed opportunities for prevention; and (3) inflated pricing and fraud. Coming out of these large, identified problem areas are a number of discrete investable themes. These are the primary target of New Leaf's investment strategy in I.C. and they include the following:

Problem Area: Inefficient Delivery and Excess Administrative Costs

- *Investment Theme - Operational & Care Delivery Efficiency*: Process improvement and optimization can only occur when data is available to identify the problems and measure the impact of solutions. With shrinking margins and shifting value objectives, healthcare providers are under pressure to understand and improve their businesses and operations. Technologies that allow the collection and analysis of relevant data on the efficiency of care-delivery will be foundational to this evolution. **AwarePoint (**NLV-II) delivers enterprise awareness solutions for the hospital and other healthcare facilities, is an example of a company fitting this theme.

in thousands of blogs and other written forums and converts this unstructured content into structured information to support better-informed decision making by patients, providers, and pharmaceutical marketing teams.

- *Investment Theme - Patient Engagement / Shift to Low-Cost Setting:* As incentives move away from procedural volume and towards cost-effective quality and outcomes, providers and care delivery organizations are seeking ways to deliver care outside of the hospital or physicians' office through technologies that may allow remote monitoring, and empowers other healthcare professionals, or even patients to play a greater role in patient care and well-being. **Audax Health** (NLV-II; exited at 3.4x) touches on this theme with its *Zensey* product, which engages patients in their own health through programs endorsed by their payer.

Problem Area: Inflated Pricing & Fraud

- *Investment Theme - Price & Cost Transparency, Financial Error Reduction*: Error reduction can generate significant cost savings at the enterprise level. **Truveris** (NLV-II) allows self-insured employers to verify the accuracy of all pharmaceutical benefit claims from their pharmacy benefit managers in real time, thus resulting in more accurate payments and significant cost savings.

These are just some of the illustrative themes for I.C. investments in NLV-III. This is an emerging area with strong growth drivers, and the Fund Managers expect the opportunity set to evolve and broaden substantially over NLV-III's investment cycle.

An intriguing aspect of this sector is the possibility for significantly shortened development timelines and product iteration cycles. Particularly because they are usually outside the jurisdiction of the FDA and standard reimbursement paths, companies in the I.C. sector can develop and launch products in months not years, and for single digit millions rather than several tens of millions of dollars. Product development for these types of applications leverages "off-the-shelf technologies" in sensors, communications, software and web design/deployment that were invented and validated in non-healthcare market segments. These products can be quickly and cheaply tested, iterated and refined in the marketplace with customers while generating early revenue, which provides a greater degree of flexibility to evolve the right solution through a series of incremental improvements rather than a single track, expensive and prolonged development effort.

The Fund's I.C. investments will be predominantly in private companies in the U.S, at or near commercialization. Similar to the biopharmaceutical strategy, New Leaf's objective in its I.C. investments is to build ownership positions that are large enough to allow the Fund Managers to exert influence on the company, and to actively manage the investments through board participation. In certain circumstances, NLV may initially take smaller positions with plans to significantly increase the Fund's investment as the companies make progress through key early technical or commercial hurdles. Utilizing this strategy, the Fund Managers expect to build larger positions around select investments as they are progressively de-risked, and may not continue to support investments that do not demonstrate appropriate progress.

The New Leaf team is one of the most experienced and proven teams in this sector. The Fund Managers' combination of proven track record, in-depth knowledge of the medical device and diagnostics fields, a strong current I.C. portfolio, and a thought-leading network of I.C. advisors, puts New Leaf in a position of leadership within this sector.

MEDICAL DEVICES INVESTMENT STRATEGY

NLV-III's investment strategy in medical devices will focus on identifying a limited number of investment opportunities in companies with compelling later stage risk profiles. The Fund will seek to identify investments in companies that are developing innovative and differentiated medical devices, targeting large market opportunities, that offer the potential to meaningfully reduce overall patient treatment costs in high morbidity disease settings through substantial efficacy and safety benefits versus existing standards of care. Investments in this sector will have established regulatory approval pathways and clear regulatory precedents, or are already at the commercial stage at the time of initial investment. The objective will be to identify companies that because of their specific therapeutic area or technology focus, or because the company already has received key regulatory approvals, that they will be less affected by the headwinds that are challenging the sector more broadly. Importantly, these investments will be in therapeutic areas that are known to be of high strategic interest to a number of larger medical device companies, and thus have a high potential of generating M&A interest. The primary risks in these investments will be mostly operational execution, competition, and other market related risks.

Similar to the second half of the investment period for NLV-II, the Fund will have a more limited focus on medical device investments in NLV-III compared to previous funds. The slower projected pace of investment is based on the view that the operating and exit environment for companies in this sector will continue to be challenging due to increased regulatory and reimbursement uncertainty in the U.S. and E.U. These headwinds have resulted in increased development costs and significantly lengthened timelines for most development stage companies.

While the Fund Managers expect to see fewer compelling investment opportunities than have been available historically in the medical device sector, they do believe that they will be able to identify and source a number of later stage opportunities that are less affected by these obstacles, and that these will be attractive investment opportunities for NLV-III. One factor that supports this view is that the reduced level of competition for deals resulting from the decline in the number of active venture capital firms mentioned previously is even more pronounced in the medical device sector. Given New Leaf's historic leadership within this sector, and its clear commitment to remain active during this period of reduced funding, the Fund Managers expect that they will have excellent deal flow. Although the number of deals in this sector is likely to be somewhat lower than in previous funds, with the later stage focus, it is likely that the size of investments in this sector will be larger. Recent medical device investments in the New Leaf portfolio that fit this later stage definition include: **Neuronetics** (NLV-II, commercial stage), **CardioKinetix** (NLV-II, clinical development stage), and **Interlace Medical** (NLV-I, start-up focused on 510k product, acquired by Hologix, exited at 8.6x).

BIOLOGICAL RESEARCH TOOLS & INFRASTRUCTURE INVESTMENT STRATEGY

NLV-III's investment strategy in Biological Research Tools and Infrastructure will focus on identifying companies that are at or near the commercial stage with novel products targeting established, high growth markets -- such as DNA sequencing and personalized medicine. The products of interest will be those based on differentiated technologies that offer higher quality biological results at significant cost savings to customers than current products. The investment theses for these companies will be based on rapidly building high-gross margins businesses that reach break-even on manageable timelines and limited capital budgets. An example of a tools company in the New Leaf portfolio is **Advanced Cellular Diagnostics** (NLV-II, commercial stage).

Research tools and infrastructure technology companies are benefiting from several positive healthcare industry tailwinds. Technology advancements over the past decade, such as genomic sequencing and personalized diagnostics, have generated the need for additional reagents and instruments to efficiently interrogate vast amounts of biological samples and process massive quantities of resulting data. Unlike biopharmaceutical or medical device product development, these new reagents are not subject to the risks of costly clinical trials, regulatory approvals and payer reimbursement. Thus, timelines are more manageable and predictable, and budgets are much more capital efficient. In fact, in this sector, the Fund Managers expect to identify opportunities for investment in technologies that have been largely de-risked, are commercial-ready, and can be funded to profitability on VC dollars. While substantial commercial adoption will likely be required for most companies in this sector to be acquired, given the high margins, rapid sales adoption, and relatively low sales and marketing costs, funding the launch of a new tool or technology in this sector can represent an attractive risk-reward investment.

This dynamic sector is growing rapidly and small companies have been a prolific source of innovative new products for the large, established companies that dominate the commercial distribution channels. The Fund will approach this sector opportunistically and will invest in a small number of companies with novel and clearly differentiated products targeting sectors of rapid growth that are at or near the commercial stage.

The Fund Managers expect investments in this sector and the medical device sector to comprise up to 15% of the Fund.

VI. DEAL SOURCING & INVESTMENT PROCESS

The Fund Managers have a proactive approach to deal sourcing, which focuses on both private and public opportunities. The established and proven sourcing activities seek to identify the most compelling healthcare technology investment opportunities, at the most attractive time points for venture capital investment. The Fund Managers' goal is to identify opportunities that are based on the most interesting novel and proprietary technologies, but place their emphasis on being positioned for investing in these technologies in the round(s) that offer the most attractive risk-adjusted returns potential. These investment opportunities are identified through a number of parallel efforts, including:

- Systematic tracking of private and public companies that have product programs and technologies targeting disease areas and biological targets of high interest that are approaching key value inflection points. Current activities include comprehensive screening of companies with programs targeting high unmet medical needs where the strength of the science coupled with a rapid and lower capital intensity development path, provides a compelling risk-reward case for investment. At the present time, the Fund Managers are tracking a biopharma investment universe of approximately 1,000 mid-late stage private and small-cap public companies, many of which are in therapeutic areas of specific interest to the Fund Managers (e.g. Oncology, Infectious Disease, Central Nervous System, etc.);

- Continuous contact with a network of current and former portfolio company management teams;

- Networking with current and former senior management team members from leading pharmaceutical, biotech, medical device, and HIT companies to understand their strategic priorities and to identify assets/programs that may become available for spinouts or structured financings;

- Staying up to date and in contact with leading academic thought leaders working in NLV's fields of interest;

- Active coverage of major investor, medical and scientific meetings; and

- Working closely with other venture capitalists with overlapping interests to ensure NLV sees the broadest range of high quality opportunities and are positioned for working with the strongest syndicates.

A key success factor behind the Fund Managers' deal sourcing activities is a strong network of entrepreneurs, industry executives, renowned clinicians, leading academic scientists, other venture investors, and experienced consultants. The Fund Managers believe that this network plays a critical role in helping to identify the most interesting opportunities, bringing the leading resources to bear to assist in due diligence, and in providing important technical and recruiting support in building portfolio companies. The Fund Managers continuously invest time and energy in updating and building this strong network to ensure access to the managers and thought leaders that are the industry's leaders in the sectors of interest.

The New Leaf team applies a rigorous, systematic, fundamentals-driven approach to diligence on all new deals, which, in addition to assessment against the sector specific strategies, includes consideration of the following risk/reward factors:

- Medical need and market size
- Competing therapies, both drugs and devices
- Strength of intellectual property
- Ease of physician adoption of new therapy
- Specific details of clinical trial design and trial execution risks
- Regulatory and reimbursement risks across relevant geographies
- Management team's ability to both execute the business plan and the exit
- Time and money required to reach next important milestone(s)
- Likely exit; potential acquirers, IPO prospects.

The Fund Managers will continue their proven investment philosophy and investment process, which emphasizes a team approach to proactive deal sourcing, rigorous investment analysis, significant involvement with portfolio companies and active management of investments and exits, and a focus on key "risk inflection" points based on the disease and technology. Investments will include both development stage and start-up stage companies, as well as growth equity or expansion capital investment in NLV-III's targeted sectors, in the private and public markets.

The Fund Managers have a long history of separating the roles of transaction finder, negotiating/closing the transaction, and board member, as needed. New Leaf seeks to put the most appropriate investment professional on the board of companies, based on experience. The Fund Managers have fostered a culture that discourages any professional from feeling the need to control all aspects of an investment. Credit is given for each professional's role, and for each team member's ability to be a team player. New Leaf seeks to avoid "lone ranger" behavior and instead actively implements a team approach.

The Fund Managers intend to create a very selective portfolio of 24 to 28 companies, which will include a balanced mix of investments in private companies and small capitalization public companies. The targeted portfolio is expected to be diversified across biopharmaceuticals (50 - 60%), information convergence (up to 25%), and the remainder across investments in later stage medical device and biological tools and infrastructure companies. While the Fund Managers believe this distribution of investments is the most likely outcome, it also intends to take full advantage of pricing discontinuities should they emerge in any of the identified sectors of interest, possibly resulting in variance from this targeted allocation.

VII. ONGOING RELATIONSHIP WITH SPROUT FUNDS

Since 2005, the Fund Managers have managed the remaining portfolio of healthcare technology investments in Sprout Capital VII, L.P., Sprout Capital VIII, L.P., and Sprout Capital IX, L.P. under a Sub-Management Agreement between Credit Suisse and New Leaf Venture Partners, L.L.C. (the "**Management Company**"). In return for these management services, the Management Company had received a portion of the management fee collected by those Sprout funds related to the healthcare portfolio.

At the present time, Sprout Capital IX, L.P. is the only fund with any remaining active healthcare technology investments. There were six active health care technology companies (three board seats) in the Sprout Capital IX, L.P. portfolio that are managed by the Fund Managers, which represented $68 million of carrying value as of March 31, 2014. These remaining investments are in mature companies and the Fund Managers intend to continue to manage the investments with an emphasis on finding exit opportunities for each company at an appropriate time. The Fund Managers have already exited a portion of these companies in early 2014, leaving a very limited tail of Sprout investments and board seats.

The Fund Managers expect the arrangement with Credit Suisse to continue for the foreseeable future, but the Management Company no longer receives any management fees for these services. The Sub-Management Agreement between Credit Suisse and the Management Company will wind down and eventually be terminated as the investments in the Sprout Capital IX, L.P. portfolio are exited.

VIII. SUMMARY OF PARTNERSHIP TERMS

The following information is presented as a summary of the Fund's principal terms only and is qualified in its entirety by reference to the Fund's Amended and Restated Limited Partnership Agreement (as amended, restated or otherwise modified from time to time, the "Partnership Agreement") and the subscription agreement relating thereto (together with the Partnership Agreement, the "Agreements"), copies of which will be provided to each prospective investor prior to the acceptance of any subscription. Prior to making any investment in the Fund, the forms of such Agreements should be reviewed carefully. If the terms described in this Memorandum are inconsistent with or contrary to the terms of the Agreements, the Agreements shall control.

The Fund:	New Leaf Ventures III, L.P., a Delaware limited partnership (the "Fund").
General Partner:	New Leaf Venture Associates III, L.P., a Delaware limited partnership (the "General Partner"), is the sole general partner of the Fund. The general partner of the General Partner is New Leaf Venture Management III, L.L.C., a Delaware limited liability company (the "GPLLC"). The initial managing members (the "Principals") of the GPLLC are Philippe Chambon, Jeani Delagardelle, Ronald Hunt, Vijay Lathi and Liam Ratcliffe.
Investment Objective:	To generate significant returns, principally through long-term capital appreciation, by making, holding and disposing of equity and equity-related investments, principally in healthcare, medical device and life sciences companies.
Size of Offering:	The Fund is targeting capital commitments ("Commitments") of $375 million with respect to limited partner interests (the "Limited Partner Interests"). The General Partner may accept a greater or lesser amount of Commitments from Limited Partners (as defined below) in its discretion.
Minimum Investment:	The minimum capital commitment of a limited partner to the Fund (collectively, the "Limited Partners" and together with the General Partner, the "Partners") will be $5 million, although individual capital commitments of lesser amounts may be accepted at the discretion of the General Partner. The General Partner may, in its discretion, reject any subscription that is tendered.
Closing(s):	The initial closing will occur as soon as practicable. The General Partner may hold additional closings thereafter; provided that the final closing will occur no later than 12 months after the initial closing (the "Final Closing Date"). Each Limited Partner admitted at a subsequent closing will be

	required to contribute the same percentage of its Commitment as each of the other Limited Partners had been required to contribute prior to such closing plus an additional amount, calculated like interest at the prime rate plus 2% per annum, compounded quarterly, on the amount of such contribution.
General Partner Commitment	The General Partner will commit to the Fund at least 1.5% of the aggregate Commitments of the Partners.
Term:	10 years, subject to the General Partner's right to extend the term for up to three one-year periods, with the approval of the Advisory Board (as defined below).
Drawdowns:	Commitments are expected to be drawn down on an as needed basis, generally, with not less than 10 business days' prior written notice. The initial capital contributions of the Partners will be due on not less than 7 business days' prior written notice.
Investment Period:	The Partners will have no obligation to make additional capital contributions to fund new investments during a Suspension Period (as defined below) or after the period commencing on the Fund's initial closing date and ending on the earliest of (i) the fifth anniversary of the Final Closing Date and (ii) the date on which a Suspension Period becomes permanent (the "Investment Period"); provided, however, that the Partners will have a continuing obligation to make capital contributions to fund prospective investments in process, follow-on investments, and to pay Fund expenses and other Fund obligations (including, without limitation, the Management Fee (as defined below) and indemnification obligations).
Diversification & Investment Limitations:	Without the approval or ratification of the Advisory Board: (a) the Fund's total investment in any single Portfolio Company shall not exceed 10% of the aggregate Subscriptions of all Partners; (b) the Fund's total investment in Portfolio Companies organized in jurisdictions outside of the United States and Canada shall not exceed 15% of the aggregate Subscriptions of all Partners; (c) the Fund may not as of any time invest more than 10% of the aggregate Subscriptions of all Partners in open market purchases of securities that, at the time of investment, are traded on a Public Securities Market and are being purchased as a stand-alone passive investment; provided, however, that for the avoidance of doubt, the foregoing restriction shall not apply

to Temporary Investments, "PIPES" and other purchases of securities in private placements that are not traded on a Public Securities Market at the time of such investment, "toe-hold" investments (e.g. investments that are intended to lead to a potential private or larger investment), Portfolio Investments where the Partnership has the right to designate a director, and follow-on investments in or related to the foregoing;

(d) the Fund shall not invest in the securities of any other pooled investment vehicle with respect to which any Person is entitled to a share of profits (whether in the form of fees, distributions or otherwise) disproportionate to its share of the contributed capital of the vehicle unless the General Partner arranges for a reduction in the Management Fee in the amount of the "management fee" and "carried interest" attributable to the Fund's interest in such vehicle; provided, however, that the Fund shall not, without the approval or ratification of the Advisory Board, invest more than 5% of the aggregate Subscriptions of all Partners in the securities of any such pooled investment vehicle; and provided, further, however, that nothing herein shall prevent the Fund from (1) investing the Fund's cash in a regulated investment company or similar entity or fund sponsored by a bank subject to the Bank Holding Company Act as a Temporary Investment or (2) investing in operating businesses through an alternative investment vehicle; or

(f) The Fund shall not invest in any uncovered options, futures contracts or other derivative securities, or sell securities short in an uncovered transaction.

Advisory Board:

The Fund will have a limited partner advisory board (the "Advisory Board") consisting of at least three persons chosen by the General Partner from persons associated with the Limited Partners; provided that neither the General Partner nor any of its affiliates may be a member of the Advisory Board. The duties of the Advisory Board (or its committees) shall be to: (a) be available to offer advice to the General Partner regarding the activities of the Fund; (b) review and advise the General Partner regarding transactions involving potential conflicts of interest submitted to them by the General Partner; (c) approve the valuation methodology formulated by the General Partner for determining the value of the Fund's assets and review periodic valuations submitted to it by the General Partner; and (d) undertake such other duties as are required by this Agreement or reasonably requested by the General Partner.

Limited Reinvestment:

Without the consent of the Advisory Board, the General Partner shall not permit the aggregate purchase price of long-term investments to exceed 110% of aggregate Commitments.

Distributions:

All distributions prior to the dissolution of the Fund will be made at such times and in such amounts as the General Partner shall determine. All such distributions will be apportioned among the Partners as follows:

(i) First, 100% to all Partners in proportion to their capital contributions until each Partner has received distributions in an amount equal to such Partner's capital contributions; and

(ii) Thereafter, 20% to the General Partner and 80% to all Partners in proportion to their respective capital contributions.

With respect to any fiscal year, the Fund may make cash distributions to the Partners in amounts intended to defray the Partners' tax liability resulting from their interests in the Fund during such fiscal year.

Liquidating distributions will be made in accordance with positive capital account balances.

Allocations:

The Fund will maintain capital accounts on behalf of each Partner in accordance with U.S. Federal income tax requirements. In general, any cumulative net loss will be allocated to the capital accounts of the Partners in proportion their contributions, and any cumulative net gain will be allocated 20% to the capital account of the General Partner and 80% to the capital accounts of all Partners in proportion to their contributions. Notwithstanding the foregoing, items of expense will be allocated to the Partners in proportion to their contributions and will be offset by subsequent allocations of net profit (to the extent thereof), provided that the General Partner will not be allocated any items of expense attributable to the Management Fee.

General Partner Clawback:

If, after the Fund has made its final liquidating distribution, the General Partner has received aggregate distributions with respect to its "carried interest" in excess of the cumulative net profit allocated to the General Partner with respect to its "carried interest," the General Partner will return to the Fund the amount of that excess; provided, however, that in no event shall the General Partner be required to return to the Fund an amount in excess of the aggregate distributions made to the General Partner that are attributable to its "carried interest" less tax distributions. All carry recipients shall be severally, but not jointly, liable for their respective proportional shares of the

Organizational Expenses: The Fund will bear expenses relating to the organization of the Fund and its affiliates and the offering of the Limited Partner Interests, including legal, accounting, travel, meeting, printing and other administrative expenses, up to an aggregate of $1,250,000. The Management Fee will be reduced by organizational expenses paid by the Fund in excess of this amount and by any placement fees paid by the Fund.

Operating Expenses: The Management Company will assume and pay all normal operating expenses attributable to the Fund's investment activities, including all routine, recurring expenses incident to the investment activities of the Fund; compensation and expenses of the employees of the Management Company and fees and expenses for administrative, clerical and related support services, maintenance of books and records for the Fund, office space and facilities, utilities, telephone and travel insofar as they relate to the investment activities of the Fund.

In addition to the Management Fee, the Fund will be responsible for all other costs and expenses of the Fund that are not reimbursed by third parties, including without limitation, organizational expenses and placement fees (each as described above); liquidation expenses of the Fund; any sales or other taxes, fees or government charges which may be assessed against the Fund; commissions or brokerage fees or similar charges incurred in connection with the purchase or sale of securities (including any merger fees payable to third parties and whether or not any such purchase or sale is consummated); fees and compensation (if any) and expenses of members of the Advisory Board (including travel-related costs and expenses); the fees and compensation (if any) and expenses of any technical or scientific advisory board with which the Fund consults; the costs and expenses (including travel-related expenses) of hosting annual or special meetings for the Partners of the Fund, or otherwise holding meetings or conferences with Partners of the Fund, whether individually or in a group; fees and expenses for consulting services; interest expense for borrowed money (if any); all expenses relating to litigation and threatened litigation involving the Fund, including indemnification expenses; expenses attributable to normal and extraordinary investment banking, commercial banking, accounting, appraisal, legal, custodial and registration services provided to the Fund, including in each case services with respect to the proposed purchase or sale of securities by the Fund that are not reimbursed by the issuer of such securities (whether or not any such purchase or sale is consummated and including expenses incurred by the tax matters partner);

premiums for liability insurance to protect the Fund, the General Partner, the partners of the General Partner, the members of the GPLLC, the members of the Advisory Board, and any of their respective partners, members, stockholders, officers, directors, trustees, employees, agents or affiliates in connection with the activities of the Fund and premiums to pay "key-man" insurance; and all other expenses properly chargeable to the activities of the Fund.

Distributions may be recalled for up to one year following the date of liquidation of the Fund to satisfy (1) any obligations, liabilities and other expenses that arise from the Fund's Portfolio Investments and (2) the Fund's indemnification obligations; provided that no Partner shall be required to return an aggregate amount greater than the lesser of (A) the aggregate amount of distributions made to such Partner (and such Partner's predecessors in interest) and (B) 25% of such Partner's Commitment

Key Person Event: The General Partner shall promptly notify the Advisory Board in writing if, prior to the end of the Investment Period, fewer than three Principals satisfy their obligation to devote substantially all of their business time to the affairs of the Management Company and its affiliates (including by reason of death or disability) for a period exceeding 60 days. Following any such occurrence, the Fund shall not make any new portfolio investments other than permitted investments (a "Suspension Period), unless such Suspension Period is lifted as provided in the Partnership Agreement.

No Fault Termination of the Investment Period: Eighty-five percent in interest of the Limited Partners may cause a termination of the Investment Period at any time after the second anniversary of the Initial Closing Date, with such termination to be effective as of the date they deliver written notice of such termination to the General Partner, after which the Fund shall not make any new portfolio investments other than permitted investments as set forth in the Partnership Agreement.

No Fault Termination of the Fund: Eighty per cent in interest of the Limited Partners (excluding affiliates of the General Partner) may vote to dissolve the Fund at any time after the second anniversary of the initial closing date upon 120 days' notice.

Removal of the General Partner for Cause: 66 2/3% in interest of the Limited Partners may remove the General Partner upon the occurrence of certain cause events specified in the Partnership Agreement.

Transferability of Interests and Withdrawal:

A Limited Partner may not sell, assign, or transfer any interest in the Fund or withdraw from the Fund except under certain limited circumstances and with the prior written consent of the General Partner.

Borrowings and Guarantees:

The Fund may borrow money on a short-term basis pending drawdowns of capital contributions in an aggregate amount outstanding at any time not exceeding 15% of aggregate Commitments, or such greater amount as is otherwise approved by the Advisory Board; provided that the maturity of any such borrowing shall not exceed 90 days. The Fund may guarantee the indebtedness of any portfolio company; provided, however, that, without the approval of the Advisory Board, the total amount of outstanding Fund guarantees shall not exceed 15% of aggregate Commitments.

Default:

If any Limited Partner defaults in the payment of any part of its Commitment when due, it will be subject to significant penalties as specified in the Partnership Agreement, including forfeiture of all or a portion of such Limited Partner's interest in the Fund.

Reports:

The Partners will receive (i) audited annual financial statements, (ii) unaudited quarterly financial statements for the first three quarters of each fiscal year, (iii) annual tax information necessary for completion of their income tax returns and (iv) periodically certain descriptive information related to portfolio investments. Reports and information, and the General Partner's obligation to provide such reports and information, will be subject to confidentiality restrictions and limitations as set forth in the Partnership Agreement. Each Limited Partner will be required to maintain information provided to it about the Fund, its business and portfolio investments in the strictest confidence and to not disclose such information except in certain limited circumstances.

Parallel Funds:

In order to facilitate investments by certain investors, the General Partner may create parallel or other investment vehicles or investment advisory programs, the structure of which may differ from that of the Fund but which will generally invest proportionately in all portfolio investments on substantially the same terms and conditions as the Fund, subject to applicable investment restrictions.

Alternative Investment Vehicles:

If the General Partner determines that for legal, tax or regulatory reasons that an investment should be made through an alternative investment vehicle, the General Partner may structure the making of all or a portion of such investment outside the Fund, by requiring some or all of the Limited Partners to make such investment through a limited liability entity that will invest on a parallel basis with, or in lieu of, the Fund, as the case may be.

Successor Fund:

Without the prior written consent of the Advisory Board, none of the General Partner, the GPLLC or any Principal may hold an initial closing for a limited partnership or other investment vehicle with an investment strategy substantially similar to the Fund (a "Successor Fund") prior to the earlier of (i) the end of the Investment Period and (ii) the date on which at least 70% of aggregate Commitments of all Partners have been invested, expended, committed, or reserved for future investments in existing portfolio companies or for reasonably anticipated Fund expenses.

Exculpation and Indemnification:

None of General Partner, the partners of the General Partner, the members of the GPLLC, the Principals, the Management Company, or any partner, member, stockholder, officer, director, manager, trustee, employee, agent or affiliate of any of the foregoing shall be liable to the Fund or any Partner for any loss suffered by the Fund or any Partner which arises out of any investment or any other action or omission of such person if (a) such person acted in good faith and reasonably believed that such course of conduct was in, or not opposed to, the best interest of the Fund and (b) such conduct did not constitute a breach of such person's fiduciary duty (if any) to the Fund, gross negligence, intentional misconduct, intentional and material breach by such person of its obligations under the Partnership Agreement (provided that such breach is not cured within 60 days of notice from a majority in interest of the Limited Partners of such breach), a willful violation of law or the commission of a felony.

No member of the Advisory Board or any other board or committee formed to assist or advise the General Partner and no Limited Partner who may have designated such member shall be liable to the Fund or any Partner for any loss suffered by the Fund or any Partner which arises out of any action or omission of such member, provided that such member acted in good faith and reasonably believed that such course of conduct was in, or was not opposed to, the best interest of the Fund and, with respect to any criminal action or proceeding, had no reasonable cause to believe that his or her conduct was unlawful.

The General Partner, the partners of the General Partner, the members of the GPLLC, the Principals, the Management Company, each liquidator, each member of the Advisory Board or any other board or committee formed to assist or advise the General Partner, each Limited Partner that designated a member of the Advisory Board, and each partner, member, stockholder, director, officer, manager, trustee, employee, agent and affiliate of any of the foregoing shall be indemnified by the Fund against any claim, demand, controversy, dispute, cost, loss, damage, expense (including attorneys' fees), judgment and/or liability incurred by or imposed upon the indemnitee in connection with any action, suit or proceeding to which the indemnitee may be made a party or otherwise involved or with which the indemnitee shall be threatened, in connection with their activities on behalf of, or their association with, the Fund; provided, however, that such an indemnitee, other than an indemnitee acting in his capacity as a member of the Advisory Board or any other board or committee formed to assist or advise the General Partner and a Limited Partner who has designated such member, shall not be indemnified with respect to matters as to which the indemnitee shall have been finally adjudicated in any such action, suit or proceeding (a) not to have acted in good faith and in the reasonable belief that the indemnitee's action was in, or not opposed to, the best interests of the Fund or (b) to have committed a breach of such person's fiduciary duty (if any) to the Fund, gross negligence, intentional misconduct, intentional and material breach by such person of its obligations under the Partnership Agreement (provided that such breach is not cured within 60 days of notice from a majority in interest of the Limited Partners of such breach), a willful violation of law or the commission of a felony. An indemnitee either acting in his capacity as a member of the Advisory Board or any other board or committee formed to assist or advise the General Partner or that is a Limited Partner who has designated such member shall not be indemnified with respect to matters as to which the indemnitee shall have been finally adjudicated in any such action, suit or proceeding (1) not to have acted in good faith and in the reasonable belief that the indemnitee's action was in, or not opposed to, the best interests of the Fund or (2), with respect to any criminal action or proceeding, such person had reasonable cause to believe that his or her conduct was unlawful.

Notwithstanding the foregoing, in no event will the Fund provide indemnification to any indemnitee for any action or omission taken by such indemnitee in such person's capacity as a director of any portfolio company in which the Fund no longer holds an investment, to the extent such liabilities solely relate to activities of such person during the period commencing 18 months after the date on which the Fund has sold or otherwise disposed of its entire interest in such portfolio

	company.
Certain ERISA Considerations:	Under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), fiduciaries of prospective investors that are retirement plans subject to ERISA ("ERISA Plans") must determine that an investment in the Fund is prudent, that such investment satisfies the requirement that plan assets be diversified and that such investment complies with the other requirements applicable to ERISA Plans. The General Partner intends to conduct the operations of the Fund so that it will be an appropriate investment for ERISA Plans. In particular, the General Partner will use reasonable best efforts to conduct the affairs and operations of the Fund in such a manner so that the assets of the Fund will not be treated as "plan assets" of any ERISA Plan for purposes of ERISA. Prospective investors that are ERISA Plans are advised to consult their own advisors as to the effect of ERISA (or other applicable law) on an investment in the Fund. The fiduciary of each prospective ERISA Plan investor must independently determine that the Fund is an appropriate investment for such ERISA Plan, taking into account the fiduciary's obligations under ERISA and the facts and circumstances of each investing ERISA Plan. (See Section X, "Certain Tax and ERISA Considerations.")
U.S. Tax-Exempt Investors:	Prospective investors are advised to consult their own tax advisors as to the tax consequences of an investment in the Fund. Subject to certain exceptions, the General Partner will use reasonable best efforts to conduct the affairs of the Fund in a manner that is not expected to cause any tax- exempt partner to realize any "unrelated business taxable income" within the meaning of Sections 512 through 514 of the Code. (See Section X, "Certain Tax and ERISA Considerations.") The General Partner's undertaking will be deemed satisfied with respect to the making, holding or disposing of any portfolio investment if the tax exempt U.S. Partners are given the opportunity to (or if all Limited Partners are otherwise required to) hold their proportionate shares of such portfolio investment directly or indirectly through an alternative investment vehicle treated as a corporation for U.S. federal income tax purposes.
Non-U.S. Investors:	Prospective investors are advised to consult their own tax advisors as to the tax consequences of an investment in the Fund. Subject to certain exceptions, the General Partner will use commercially reasonable efforts to conduct the affairs of the Fund in a manner that is not expected to cause the Fund to be treated for United States federal income tax purposes as engaged in a "trade or business within the United States,"

	within the meaning of Section 864(b) of the Code. (See Section X, "Certain Tax and ERISA Considerations.") The General Partner's undertaking will be deemed satisfied with respect to the making, holding or disposing of any portfolio investment if the Non U.S. Partners are given the opportunity to (or if all Limited Partners are otherwise required to) hold their proportionate shares of such portfolio investment directly or indirectly through an alternative investment vehicle treated as a corporation for U.S. federal income tax purposes.
Risk Factors:	An investment in the Fund involves a high degree of risk. Prospective investors should carefully review the matters discussed under Section IX, "Certain Investment Considerations."
Legal Counsel:	Proskauer Rose LLP

IX. CERTAIN INVESTMENT CONSIDERATIONS

An investment in the Fund entails a significant degree of risk and, therefore, should be undertaken only by investors capable of evaluating the risks of the Fund and bearing the risks it represents. There can be no assurance that the Fund's investment objectives will be achieved or that an investor will receive a return of its capital, and therefore, an investor should only invest in the Fund if such investor is able to withstand a total loss of its investment. In addition, there will be occasions when the General Partner and its affiliates may encounter potential conflicts of interest in connection with the Fund. Prospective investors in the Fund should carefully consider the following factors in connection with an investment in the Fund. The following is not a complete list of all risks involved in connection with an investment in the Fund. In addition to the items discussed below, prospective investors should also consider the information described in Section XI, "Certain Tax & ERISA Considerations" and elsewhere in this Memorandum. Prospective investors are cautioned not to rely on the prior returns set forth in this Memorandum in making a decision whether or not to purchase the Limited Partner Interests offered hereby. The return information contained in this Memorandum has not been audited or verified by any independent party and should not be considered representative of the returns that may be received by an investor in the Fund. Past performance is not a guarantee of future results.

Risk of Venture Capital Investments
While venture capital investments offer the opportunity for significant gains, such investments also involve a high degree of business and financial risk and can result in substantial losses. Among these risks are the general risks associated with investing in companies at an early state of development or with little or no operating history, companies operating at a loss or with substantial variations in operating results from period to period, and companies with the need for substantial additional capital to support expansion or to achieve or maintain a competitive position. Such companies may face intense competition, including from companies with greater financial resources, more extensive development, manufacturing, marketing and service capabilities and a larger number of qualified managerial and technical personnel. Due to the limited number of investments that the Fund may make, poor performance by some of the Fund's investments could significantly affect the total returns to Limited Partners.

Focused Investment Strategy
The Fund will be focused on life sciences and healthcare technology investments and may not enjoy the reduced risks of a broadly diversified portfolio. A specific investment focus is inherently more risky and could cause the Fund's investments to be more susceptible to particular economic, political, regulatory, technological or industry conditions or occurrences compared with a fund, or a portfolio of funds, that is more diversified or has a broader industry focus.

Risks Associated with Investments in Life Sciences and Healthcare Technology Companies
The success of the Fund's portfolio companies may be dependent upon obtaining certain governmental approvals. Companies in the life sciences and healthcare technology industry typically require the approval of agencies such as the FDA prior to marketing their products to the public. Of particular significance are the FDA requirements covering research and development, testing, manufacturing, quality control, labeling and promotion of drugs for human use. The approval process is very lengthy and very costly, and there can be no guarantee that a portfolio company will obtain the necessary approvals for its products. If a portfolio company is unable to obtain these approvals in a timely fashion, the portfolio

company may experience significant adverse effects, which in turn could negatively affect the performance of the Fund. Moreover, the current regulatory framework may change or additional regulations may arise at any stage during the product development phase of a portfolio company, which may affect the company's ability to obtain approval of its products.

The Fund may invest in companies that will need to obtain patents for their products, both in the U.S. and in other countries. The patent protection of the intellectual property of healthcare technology companies in many countries is highly uncertain and involves complex legal, scientific and factual issues. The policy regarding allowable claimed subject matter of life sciences or healthcare technology patents varies from jurisdiction to jurisdiction.

Dependence on Single Products

Companies in which the Fund invests may only have one product under development. There can be no assurance that the product will be approved for marketing by the FDA or any foreign regulatory agency. Further, competition to the product may develop from other new and existing products. In either case, if a company is dependent on that one product, the consequences of such failure could be devastating to the prospects of such company, which in turn could negatively affect the performance of the Fund.

Dependence on Reimbursement and Third-Party Pricing Policies for Products

The ability of the Fund's portfolio companies to commercialize any product candidate successfully also will depend in part on the extent to which reimbursement for these products and related treatments will be available from government health administration authorities, private health insurers and other organizations. Government authorities and third-party payors, such as private health insurers and health maintenance organizations, decide which medications they will pay for and establish reimbursement levels. A major trend in the U.S. healthcare industry and elsewhere is cost containment. Government authorities and third-party payors, particularly Medicare, have attempted to control costs by limiting coverage and the amount of reimbursement for particular medications. Increasingly, third-party payors are requiring that drug companies provide them with predetermined discounts from list prices and are challenging the prices charged for medical products. Portfolio companies cannot be sure that coverage and reimbursement will be available for any product that they commercialize, and, even if these are available, the level of reimbursement may not be satisfactory.

Reimbursement may affect the demand for, or the price of, any product candidate for which a portfolio company obtains marketing approval. Obtaining and maintaining adequate reimbursement for a portfolio company's products may be particularly difficult because of the higher prices often associated with drugs administered under the supervision of a physician or because a drug may be administered in combination with other drugs that may carry high prices. A portfolio company may be required to conduct expensive pharmacoeconomic studies to justify coverage and reimbursement or the level of reimbursement relative to other therapies. If coverage and adequate reimbursement are not available or reimbursement is available only to limited levels, a portfolio company may not be able to successfully commercialize any product candidate for which it obtains marketing approval. This, in turn, could negatively affect the performance of the Fund.

There may be significant delays in obtaining reimbursement for newly approved drugs, and coverage may be more limited than the purposes for which the drug is approved by the FDA or similar regulatory authorities outside the United States. Moreover, eligibility for reimbursement does not imply that any drug will be paid for in all cases or at a rate that covers a portfolio company's costs, including research, development, manufacture, sale and distribution. Interim reimbursement levels for new drugs, if applicable, may also not be sufficient to cover a portfolio company's costs and may not be made permanent. Reimbursement rates may vary according to the use of the drug and the clinical setting in which it is used, may be based on reimbursement levels already set for lower cost drugs, and may be incorporated into existing payments for other services. Net prices for drugs may be reduced by mandatory discounts or rebates required by government healthcare programs or private payors and by any future relaxation of laws that presently restrict imports of drugs from countries where they may be sold at lower prices than in the United States. Third-party payors often rely upon Medicare coverage policy and payment limitations in setting their own reimbursement policies. A portfolio company's inability to promptly obtain coverage and profitable payment rates from both government-funded and private payors for any approved products that a portfolio company may develop could have a material adverse effect on its operating results, its ability to raise capital needed to commercialize products and its overall financial condition. This, in turn, could negatively affect the performance of the Fund.

Political Risk; Current and Future Healthcare Reforms

Political events can have an impact on pharmaceutical and biotechnology companies. There can be no guarantee that government's role in the healthcare industry will not adversely impact the performance of the Fund.

In both the U.S. and foreign markets, sales of healthcare products and services and their success will depend in part on the availability of reimbursement from third-party payors such as government health administration authorities, private health insurers, and other organizations. The levels of revenues and profitability of providers of healthcare products and services may be affected by the continuing efforts of governmental and third-party payors to contain or reduce the costs of health care. Significant uncertainty exists as to the reimbursement status of newly approved health care products. There can be no assurance that a company's proposed products or services will be considered cost-effective or that adequate third-party reimbursement will be available to enable a company to maintain price levels sufficient to realize an appropriate return on its investment.

Moreover, there continues to be significant interest among policy makers and government and private payors in the United States and foreign jurisdictions in promoting changes in healthcare systems to contain healthcare costs and improve the overall quality of care and wellness.

For example, on March 23, 2010, President Obama signed into law the Patient Protection and Affordable Care Act, which Congress modified pursuant to the Health Care and Education Reconciliation Act of 2010 (collectively, the "Act"). The Act expands insurance coverage to more individuals, which could have a negative impact on the pharmaceutical industry. Among the aspects of the Act that may have an adverse impact on the Fund are (i) mandatory annual fees on pharmaceutical manufacturers, (ii) discounts of 50% on brand name prescription drugs for certain Medicare Part D beneficiaries (i.e., those who are required to pay 100% of their prescription drug costs during the temporary "gap" from Medicare coverage until their prescription drug costs reach the threshold for catastrophic coverage by Medicare), (iii) an approval process for generic biologics and granting exclusive marketing rights to original manufacturers for 12 years, (iv) increased drug rebates to the Medicaid program, and (v) disclosure requirements for financial relationships between various healthcare entities.

Within the U.S., the pharmaceutical industry has been a particular focus of both state and federal governments' reform efforts. Other than reform measures adopted in the Act, proposed reforms include, but are not limited to, the following:

- increasing regulation of pharmaceutical sales representatives;
- restricting direct to consumer advertising and off-label uses;
- limiting manufacturers' access to marketing data;
- authorizing the importation of drugs from Canada and other foreign countries to lower pharmaceutical costs to U.S. consumers;
- price discounts, formularies or rebates to government healthcare programs; and
- allowing government healthcare programs to negotiate prescription drug prices directly with manufacturers.

While the Fund cannot predict which legislative or regulatory proposals will be adopted or what affect the adopted proposals, including the Act, may have on the biopharmaceutical companies in which the Fund invests, the pendency, approval or implementation of such proposals could decrease the Fund's anticipated returns or adversely affect its investment opportunities.

Availability of Investment Capital

Many portfolio companies will require several rounds of capital infusions before reaching maturity. The Fund and its co-investors may not provide all necessary follow-on capital to portfolio companies. Accordingly, third-party sources of financing may be required. There is no assurance that such additional sources of financing will be available, or, if available, will be on terms beneficial to the Fund. Furthermore, the Fund's capital is limited and may not be adequate to protect the Fund from dilution resulting from multiple rounds of portfolio company financings. If the Fund does not have capital available to participate in subsequent rounds of financing, failure to participate may have a significant negative impact on the portfolio company as well as the value of the Fund's investment.

Economic and Market Risk

Companies in which the Fund invests may be sensitive to general downward swings in the overall economy or in the healthcare technology sector. Changes in economic conditions, including, for example, inflation rates, industry conditions, competition, technological developments, political and diplomatic events and trends, tax laws and innumerable other factors, none of which will be within the control of the General Partner, can affect substantially and adversely the business and prospects of the Fund. A major recession or adverse developments in the securities market might have an impact on some or all of the Fund's investments. In addition, factors specific to a portfolio company may have an adverse effect on the Fund's investment in such company. The General Partner may rely upon its own or a portfolio company's projections concerning the portfolio company's future performance in making investment decisions. Such projections are inherently subject to uncertainty and to certain factors beyond the control of the portfolio company and the General Partner. The economic environment for all companies, and in particular for healthcare technology and start-up companies, may remain challenging. Business risks may be more significant in portfolio companies embarking on a build-up or operating turnaround strategy and in smaller or development stage portfolio companies. All portfolio companies may face intense competition, changing business and economic conditions, risks of technological acceptance and obsolescence or other developments that may adversely affect their performance.

Illiquidity of Portfolio Investments
Investments by the Fund generally will be illiquid securities acquired through privately negotiated transactions. The Fund may be unable to realize its investment objectives by sale or other disposition at attractive prices or will otherwise be unable to complete an exit strategy. External factors beyond the General Partner's control, such as overall economic conditions, the competitive environment and the availability of potential acquirors of the Fund's interests in portfolio companies may shorten or lengthen the Fund's holding period in such portfolio companies. In some cases, the Fund may be prohibited by contract from selling such securities for a period of time or otherwise may be restricted from the disposition of such securities.

Lack of Operating History
The Fund and the General Partner are newly formed entities, and, accordingly have no operating history or investments upon which investors can evaluate the potential performance of the Fund. The prior performance of the Fund Managers or their investments as described in this Memorandum is not necessarily indicative of the Fund's future results. There can be no assurance that investments by the Fund will achieve returns comparable to the historical performance reflected in this Memorandum, and in any event, the returns achieved by the Fund will be subject to the Management Fee and the General Partner's carried interest. Any given investment made by the Fund may prove to be worthless, and there is a risk that investors could lose money.

No Assurance of Profit or Distributions
The Fund's task of identifying opportunities in private and public operating companies, managing such investments and realizing a significant return for investors is difficult. Many organizations operated by persons of competence and integrity have been unable to make, manage and realize such investments successfully. There is no assurance that the investments of the Fund will be profitable or that any distribution will be made to the Limited Partners. Any return on investment to the Limited Partners will depend upon successful investments being made by the Fund. The marketability and value of any such investment will depend upon many factors beyond the control of the Fund. The Fund may not have sufficient cash available to make tax distributions to the Partners. The expenses of the Fund may exceed its income, and the Limited Partners could lose the entire amount of their contributed capital. Accordingly, prospective investors should not subscribe to the Fund unless they can readily bear the consequences of such a loss.

Competition
The business of identifying, structuring and implementing venture capital investments, along with other investments within the strategy of NLV-III is highly competitive. The Fund will be competing for investments against other groups, including institutional investors, investment managers and industrial groups owned by large and well-capitalized investors. It is possible

that competition for appropriate investment opportunities may limit significantly the number of opportunities available to the Fund and adversely affect the terms upon which investments can be made. There can be no assurance that the Fund will be successful in its efforts to identify attractive investment opportunities, and it is possible that the Fund's Commitments will not be fully utilized if sufficient attractive investments are not identified and consummated by the Fund during the Investment Period.

Management of the Fund

The General Partner will make decisions with respect to the management of the Fund. Limited Partners have no right or power to take part in the management of the Fund. The Limited Partners will not receive the detailed financial information issued by portfolio companies that will be available to the Fund. Accordingly, the Limited Partners will not have the opportunity to evaluate the relevant economic, financial and other information that will be utilized by the General Partner in its selection of investments. An investor in the Fund must rely upon the ability of the General Partner with the assistance of the Management Company to identify, structure, and implement investments consistent with the Fund's investment objectives and policies. Accordingly, no person should purchase Limited Partner Interests unless such person is willing to entrust all aspects of the management of the Fund to the General Partner.

Reliance on Management of Fund

The success of the Fund will be largely dependent upon the activities of the Fund Managers. The loss of one or more of these individuals could have a significant adverse impact on the business of the Fund and its financial performance.

Reliance Upon Portfolio Company Management

Although the Fund may seek representation on the board of directors of each of the portfolio companies or otherwise provide management and strategic planning assistance, the Fund will not have an active role in the day-to-day management of the companies in which it invests. To the extent that the senior management of a portfolio company performs poorly, or if a key manager of a portfolio company terminates employment, the Fund's investment in such company could be adversely affected.

Potential Conflicts of Interest

The Fund Managers will continue to devote a portion of their time to the business of the Sprout Funds, NLV-I, NLV-II and to any future funds that they may organize in accordance with the Partnership Agreement. Conflicts may arise in the allocation of investment opportunities and the Fund Managers' time among the Fund and other such partnerships and any such future funds. Prospective investors should be aware that there may be occasions when the General Partner, the Fund Managers, the Management Company and their affiliates will encounter potential conflicts of interest in connection with the Fund's activities. The Partnership Agreement will contain certain protections for Limited Partners against conflicts of interest faced by the General Partner and its partners, but will not purport to address all types of conflicts that may arise. Moreover, as a practical matter, it may be difficult for Limited Partners to subject the behavior of the General Partner, the Management Company and their partners to close scrutiny.

Profits Not Shared in Proportion to Contributed Capital
The capital contribution of the General Partner will represent only a small portion of the Fund's capital. Limited Partners may invest greater amounts and may receive a proportionately smaller amount of the profits of the Fund than the General Partner. The General Partner may have an incentive to make investments that are riskier or more speculative than if the General Partner received allocations on a basis identical to that of the Limited Partners in the Fund or was compensated on a basis not tied to the performance of the Fund.

Investment Opportunities
The General Partner may in certain circumstances allocate investment opportunities to prior funds or potential successor funds. Allocation of investment opportunities will be made in good faith by the General Partner. There can be no assurance that the allocation of investment opportunities by the General Partner will not give rise to conflicts of interest between the investors of the respective funds.

Long-Term Investment
An investment in the Fund is a long-term commitment, and there is no assurance of any distribution to the Limited Partners prior to or upon liquidation of the Fund.

Illiquidity of Limited Partner Interests
The Limited Partner Interests are highly illiquid. There is no public market for the Limited Partner Interests and none is expected to develop. Limited Partner Interests in the Fund may not be assigned, transferred or encumbered without the prior written consent of the General Partner. Voluntary withdrawals of Limited Partner Interests are not permitted, except in limited circumstances where necessary to comply with laws or regulations applicable to a Limited Partner. Consequently, a Limited Partner may not be able to liquidate their investment in the event of a change in circumstances or for other reasons and, therefore, must be prepared to bear the risks of owning its interest in the Fund for an extended period of time. The Limited Partner Interests will not be registered under the Securities Act of 1933, as amended (the "Securities Act"), or under the various "Blue Sky" or securities laws of the state or jurisdiction of residence of any Limited Partner of the Fund. The Limited Partner Interests are being offered only to "accredited investors" under an exemption in Section 4(2) of the Securities Act and the rules of the Securities and Exchange Commission thereunder and exemptions under the various applicable "Blue Sky" and other state securities laws.

Bridge Financings and Guarantees
From time to time, the Fund may lend to portfolio companies on a short-term, unsecured basis or guaranty portfolio company obligations in anticipation of a future issuance of equity or long-term debt securities. Such bridge loans would typically be convertible into a more permanent, long-term security; however, for reasons not always in the Fund's control, such long-term securities may not issue and such bridge loans or guarantees may remain outstanding. In such event, the interest rate on such loans or compensation for such guaranty (if any) may not adequately reflect the risk associated with the unsecured position taken or guaranty given by the Fund.

Portfolio Company Leverage

To the extent that any investment is made in a portfolio company with a leveraged capital structure, such investment will be subject to increased exposure to adverse economic factors such as a significant rise in interest rates, a severe downturn in the economy or deterioration in the condition of such company or its industry. If such a company is unable to generate sufficient cash flow to meet principal and interest payments on its indebtedness, the value of any equity investment by the Fund in such company could be significantly reduced or even eliminated.

Investments in Public Companies

The Fund may invest in public companies or take private portfolio companies public. Investments in public companies may subject the Fund to risks that differ in type or degree from those involved with investments in privately held companies. Such risks include, without limitation, greater volatility in the valuation of such companies, increased obligations to disclose information regarding such companies, limitations on the ability of the Fund to dispose of securities at certain times (including due to the possession by the Fund of material non-public information), increased likelihood of shareholder litigation against such companies' board members, which may include the Fund Managers or other Management Company personnel, regulatory action by the U.S. Securities and Exchange Commission and increased costs associated with each of the aforementioned risks.

Hedging Techniques

From time to time, the Fund might have investments that are publicly traded, yet illiquid. The General Partner might engage in hedging techniques, such as selling the corresponding shares short "against the box," to "lock in" or secure the value in an investment until it becomes liquid and freely tradable. The Fund will only sell short a stock to the extent it holds a corresponding long and illiquid position in the same company.

Portfolio Trading

The Fund does not generally intend to trade its assets for short-term profits, however, when circumstances warrant, securities may be sold by the Fund without regard to the length of time held. Any active short-term trading of the Fund will increase its rate of turnover and related transaction expenses.

Non-U.S. Investments

The Fund may invest a portion of Fund's total committed capital in the securities of issuers that are organized outside of the U.S. and Canada. Investing in non-U.S. securities may involve substantially greater risks than investing in U.S. securities including risks relating to (i) currency exchange matters, including fluctuations in the rate of exchange between the U.S. dollar and the various foreign currencies in which the Fund's non-U.S. investments are denominated, and costs associated with conversion of investment principal and income from one currency to another; (ii) differences between the U.S. and non-U.S. securities markets, including potential price volatility in and relative illiquidity of some non-U.S. securities markets; (iii) the absence of uniform accounting, auditing and financial reporting standards, practices and disclosure requirements, and differences in government supervision and regulation; (iv) certain economic and political risks, including potential exchange control regulations, potential restrictions on foreign investments and repatriation of capital and the risks associated with political, economic or social instability, diplomatic developments, and the possibility of expropriation or confiscatory taxation; and (v) the possible imposition of non-U.S. taxes on income and gains recognized with respect to such securities. While the General Partner will take these factors into consideration in making investment decisions for the Fund and intends to manage the Fund in a manner to minimize exposure to the foregoing risks, there can be no assurance that the General Partner will be able to evaluate the risks accurately or that adverse developments with respect to such risks will not adversely affect the value or realization of investments that are held by the Fund in certain countries.

Reserves

As is customary in the industry, the General Partner may establish reserves for follow-on investments by the Fund in portfolio companies, operating expenses (including the Management Fee), Fund liabilities, and other matters. Estimating the appropriate amount of such reserves is difficult, especially for follow-on investment opportunities, which are directly tied to the success and capital needs of portfolio companies. Inadequate or excessive reserves could impair the investment returns to the Limited Partners. If reserves are inadequate, the Fund may be unable to take advantage of attractive follow-on or other investment opportunities or to protect its existing investments from dilutive or other punitive terms associated with "pay-to-play" or similar provisions. If reserves are excessive, the Fund may decline attractive investment opportunities or hold unnecessary amounts of capital in money market or similar low-yield accounts.

Diverse Investors

The Limited Partners may have conflicting investment, tax, and other interests with respect to their investments in the Fund. The conflicting interests of individual Limited Partners may relate to or arise from, among other things, the nature of investments made by the Fund, the structuring or the acquisition of investments and the timing of disposition of investments. As a consequence, conflicts of interest may arise in connection with decisions made by the Fund Managers, including with respect to the nature or structuring of investments that may be more beneficial for some Limited Partners than for others, particularly with respect to investors' individual tax situations. In selecting and structuring investments appropriate for the Fund, the General Partner will consider the investment and tax objective of the Fund and the Partners as a whole, not the investment, tax or other objective of any Limited Partner individually.

Failure of Limited Partners to Fulfill Their Commitment Obligations

The Fund's investments in portfolio companies will require capital calls on Limited Partners over an extended period of time. Failure by a Limited Partner to meet a capital call could result in the failure of the Fund to make desired investments, which could have adverse consequences for the Fund and thus all of the Limited Partners. The failure by the Fund to receive a significant portion of capital contributions due from Limited Partners in respect of their Commitments could materially impair the Fund's ability to realize its financial objectives. In the event that a Limited Partner defaults, such Limited Partner may be subject to various penalties, including forfeiture of all or a portion of its interest in the Fund, as provided in the Partnership Agreement.

Risk of Dilution

Limited Partners subscribing for interests at subsequent closings will participate in existing investments of the Fund, diluting the interest of existing Limited Partners therein. Although such Limited Partners will contribute their pro rata share of prior capital contributions previously drawn down by the Fund (plus an additional amount thereon), there can be no assurance that such payment will reflect the fair value of the Fund's existing investments at the time such additional Limited Partners subscribe for such interests.

Difficulty in Valuing Portfolio Investments and Distribution in Kind
Generally, there will be no readily available market for a substantial number of the Fund's investments and hence, most of the Fund's investments will be difficult to value. The securities in which the Fund will invest may be among the most junior in a portfolio company's capital structure, and thus subject to the greatest risk of loss. It is highly speculative as to the whether and when a portfolio company will be able to register its securities so that the securities become eligible for trading in public markets. Certain investments may be distributed in kind to the Partners of the Fund. An investor that receives assets other than cash from the Fund may incur costs and delays in converting those assets to cash.

Non-Controlling Investments
The Fund generally expects to make non-controlling investments in portfolio companies where the Fund may not be able to control or effectively influence the business or affairs of such entities. Portfolio companies in which the Fund's investments are made may have economic or business interests or goals which are inconsistent with those of the Fund, and the Fund may not be in a position to influence those interests or goals or otherwise protect the value of the Fund's investments in such entities. In addition, although the Fund may seek board representation in connection with its investments, there is no assurance that such representation, if sought, will be obtained.

Service on Board of Directors
The Fund typically will seek to have observation or visitation rights or the right to designate directors to serve on the boards of directors of the Fund's portfolio companies. In addition, affiliates of the General Partner may serve, from time to time, as officers or directors of the portfolio companies. The foregoing rights and activities could expose the General Partner, its affiliates and the assets of the Fund to regulatory action and/or lawsuits and claims by a portfolio company, its security holders and its creditors. While the General Partner intends to manage the Fund in a way that will minimize exposure to these risks, the possibility of successful claims or lawsuits or adverse regulatory action cannot be eliminated, and such events could have significant adverse effects on the Fund.

Material Non-Public Information
By reason of their responsibilities in connection with their other activities, certain affiliates of the General Partner may acquire confidential or material non-public information or be otherwise restricted from initiating transactions in certain securities. The Fund will not be free to act upon any such information. Due to these restrictions, the Fund may be not be able to initiate a transaction that it otherwise might have initiated and may not be able to sell an investment that it might otherwise might have sold.

In their capacity as officers or directors, affiliates of the General Partner will be subject to fiduciary or other duties to the portfolio company, which may adversely affect the Fund. For example, the Fund may be prohibited from selling publicly traded securities of a portfolio company if the General Partner or any of its affiliates is in possession of material non-public information relating to such company.

Recourse to the Fund's Assets

The Fund's assets, including any investments made by the Fund and any funds held by the Fund, are available to satisfy all liabilities and other obligations of the Fund. If the Fund becomes subject to a liability, parties seeking to have the liability satisfied may have recourse to the Fund's assets generally and will not be limited to any particular assets, such as the asset representing the investment giving rise to the liability. Accordingly, investors could find their interest in the Fund's assets adversely affected by a liability arising out of an investment of the Fund.

Contingent Liabilities on Disposition of Investments

In connection with the disposition of an investment in a portfolio company or otherwise, the Fund may be required to make representations about the business and financial affairs of the portfolio company typical of those made in connection with the sale of any business. The Fund may also be required to indemnify the purchasers of such portfolio company to the extent that any such representations turn out to be inaccurate. These arrangements may result in contingent liabilities, which might ultimately have to be funded by the investors to the extent of their Commitment to the Fund or previous distributions made to them.

Certain Litigation Risks

The Fund will be subject to a variety of litigation risks, particularly if one or more of its portfolio companies face financial or other difficulties during the term of the Fund. Legal disputes, involving any or all of the Fund, the General Partner, its partners or its affiliates, may arise from the Fund's activities and investments and could have a significant adverse effect on the Fund.

Indemnification

The Fund will be required to indemnify, among others, the General Partner, the general partner of the General Partner, the Management Company, the Fund Managers, their respective partners, members, employees, venture partners and affiliates, the Fund's other agents and members of the Advisory Board for liabilities incurred in connection with the affairs of the Fund. Such liabilities may be material. For example, in their capacity as directors of portfolio companies, the partners, managers, or affiliates of the General Partner may be subject to derivative or other similar claims brought by security holders of such companies. The indemnification obligations of the Fund would be payable from the assets of the Fund, including the unused capital commitments of the Partners. If the assets of the Fund are insufficient to pay such indemnification obligations, the Limited Partners may be required to return distributions previously made to them in order to satisfy such obligations.

Changes

The Fund's investment program is intended to extend over a period of years, during which the business, economic, political, regulatory, and technology environment within which the Fund operates may undergo substantial changes, some of which may be adverse to the Fund. The General Partner will have the exclusive right and authority (within limitations set forth in the Partnership Agreement) to determine the manner in which the Fund shall respond to such changes, and Limited Partners generally will have no right to withdraw from the Fund or to demand specific modifications to the Fund's operations in consequence thereof. A major recession or adverse developments in the securities or credit markets might have an impact on some or all of the Fund's investments. A sustained period of inactivity and/or low valuations in the public equity markets could result in substantially lower liquidation values and substantially longer periods before liquidity is achieved in comparison with historical values, which would reduce the returns that could be achieved by the Fund. In addition, factors specific to a portfolio company may have an adverse effect on the Fund's investment in such company. The General Partner may rely upon its own or a portfolio company's projections concerning the portfolio company's future performance in making investment decisions. Such projections are inherently subject to uncertainty and to certain factors beyond the control of the portfolio company and the General Partner. Prospective investors are particularly cautioned that the investment sourcing, selection, management and liquidation strategies and procedures exercised by partners of the General Partner in the past may not be successful, or even practicable, during the Fund's term.

Industry Specific Terminology

Prospective investors are cautioned that certain terms and phrases of common usage within the venture capital industry may be misleading to those unfamiliar with such usage. In particular, individuals who participate in the management of a fund often are referred to, in a colloquial sense, as "general partners" even though they are not actually general partners of any partnership. Prospective investors are reminded that the Fund will be a limited partnership, that the General Partner will be a limited partnership, that the general partner of the General Partner will be a limited liability company, and that the individuals directing the management of the Fund through the General Partner will be members of such limited liability company. It is not intended that the Fund will have any general partner other than the General Partner or that any actual general partnership will in any manner be associated with the formation, operation, dissolution or termination of the Fund. Prospective investors must not presume or rely upon the existence of any actual legal entities other than the Fund, the General Partner and the general partner of the General Partner. With respect to all matters involving industry specific terminology, prospective investors are urged to consult with their own legal and other advisors.

Fund and General Partner Not Registered

The Fund will not be registered under the Investment Company Act of 1940, as amended (the "Investment Company Act") pursuant to an exemption set forth in Sections 3(c)(1) and/or 3(c)(7) of the Investment Company Act. There is no assurance that such exemptions will continue to be available to the Fund. Due to the burdens of compliance with the Investment Company Act, the performance of the Fund's investment portfolio could be materially adversely affected, and risks involved in financing portfolio companies could substantially increase, if the Fund becomes subject to registration under the Investment Company Act. Neither the Fund nor its counsel can assure investors that, under certain conditions, changed circumstances, or changes in the law, the Fund may not become subject to the Investment Company Act or other burdensome regulation. The General Partner is not registered as a broker/dealer under the Securities Exchange Act of 1934, as amended (the "Exchange Act") and with the National Association of Securities Dealers, Inc. (the "NASD") and is consequently not subject to the record keeping and specific business practice provisions of the Exchange Act and the rules of the NASD.

Tax Risks
Certain tax risks relating to an investment in the Fund are discussed in Section XI "Certain Tax & ERISA Considerations", which prospective investors should read carefully. No assurances can be given that current tax laws, rulings and regulation will not be changed during the life of the Fund. Prospective Limited Partners should consult their tax advisors for further information about the tax consequences of purchasing a Limited Partner Interest in the Fund.

Withholding and Other Taxes
The General Partner intends to structure the Fund's investments in a manner that is intended to achieve the Fund's investment objectives and, notwithstanding anything contained herein to the contrary, there can be no assurance that the structure of any investment will be tax efficient for any particular investor or that any particular tax result will be achieved. In addition, tax reporting requirements may be imposed on investors under the laws of the jurisdictions in which investors are liable to taxation or in which the Fund makes portfolio investments. Prospective investors should consult their own professional advisors with respect to the tax consequences to them of an investment in the Fund under the laws of the jurisdiction in which they are liable to taxation. Furthermore, the Fund's returns in respect of its investments may be reduced by withholding or other taxes imposed by jurisdictions in which the Fund's portfolio companies are organized.

Confidential Information
The Partnership Agreement will contain confidentiality provisions intended to protect proprietary and other information relating to the Fund and the Fund's portfolio companies. To the extent that such information is publicly disclosed, competitors of the Fund and/or competitors of its portfolio companies, and others, may benefit from such information, thereby adversely affecting the Fund, its portfolio companies and the General Partner and the economic interests of Limited Partners.

Written Agreements
The Fund, the General Partner and the Management Company will be authorized, without the approval of any Limited Partner, to enter into side letters or similar written agreements with Limited Partners that have the effect of establishing rights under, or altering or supplementing the terms of this Memorandum, the Partnership Agreement, such Limited Partner's Subscription Agreement or other related agreements. The ability of other Limited Partners to receive copies of and/or elect to receive the benefit of such side agreements will be limited.

Market volatility
Since 2008, the capital, credit and securities markets have been experiencing unprecedented levels of volatility and disruption. Ongoing volatility could negatively impact the Fund in a number of ways. Many of the investments purchased, held and sold on behalf of the Fund may be complex, and their market values will be highly sensitive to market changes. Overall Fund returns may be reduced as relatively small changes in the capital, credit or securities markets may have significant impacts on the profitability of Fund investments. In addition, the U.S. Congress and regulatory agencies may adopt new financial regulations and tax policies in response to continued volatility, which could restrict the Fund's investment options and be otherwise unfavorable to the Fund.

Regulatory Changes
On June 22, 2011, to implement provisions of Title IV of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the U.S. Securities and Exchange Commission (the "SEC") adopted final rules implementing new exemptions from the registration requirements of the Investment Advisers Act of 1940 (the "***Advisers Act***"), one of which is commonly known as the venture capital fund exemption. Neither the General Partner nor the Management Company is currently expected to register as an investment adviser with the SEC in reliance on the venture capital fund exemption. The General Partner may need to take into consideration certain conditions regarding the nature of investments that may be made by investment vehicles advised by an investment adviser relying on the venture capital exemption, which may constrain the Fund's investment flexibility or require certain non-qualifying investments to be disposed of earlier than they might otherwise be. In addition, compliance with the venture capital fund exemption may subject the Fund to limitations on the Fund's operations, including limitations on the Fund's ability to borrow, provide guarantees and make short-term investments that are more restrictive than any limitation set forth in the Partnership Agreement.

Reliance on the venture capital exemption also will necessitate reporting certain information to the SEC about the Management Company, the General Partner and their affiliates and may result in such entities being subject to SEC examination authority and certain Advisers Act compliance obligations. If the General Partner and the Management Company are able to rely on the venture capital exemption, investors in the Fund will not be entitled to the benefits of certain protections under the Advisers Act. If the General Partner or the Management Company cannot rely on the venture capital exemption, the General Partner or the Management Company may need to register as an investment adviser under the Advisers Act. Registration under, and compliance with, the Advisers Act could be costly and could divert attention of the Fund's management team. There also can be no assurance that statutory, regulatory, judicial or administrative interpretations of existing laws and regulations will not in the future impose more comprehensive or stringent requirements on the General Partner or the Management Company.

Cautionary Statements Regarding Forward-Looking Statements. Certain information contained in this Memorandum constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may," "will," "should," "expect," "anticipate," "project," "estimate," "intend," "continue," or "believe," or the negatives thereof or other variations thereon or comparable terminology. Such forward-looking statements, including the intended actions and performance objectives for the Fund, involve known and unknown risks, uncertainties and other important factors that could cause actual results, performance or achievements of the Fund to differ materially from any future results, performance or achievements expressed or implied by such forward-looking statements. Although this information was prepared by the General Partner based on its experience in the industry and on assumptions of fact and opinion as to future events that the General Partner believed to be reasonable when made, no representation is made or assurance given that such statements, views, projections or forecasts are correct or that the objectives of the Fund will be achieved or that investors will receive a return of their capital. Moreover, neither the Fund nor the General Partner, nor any of their affiliates, assumes responsibility for the accuracy and completeness of any forward-looking statements. All forward-looking statements in this Memorandum speak only as of the date of this Memorandum. The Fund, the General Partner and their affiliates expressly disclaim any obligation or undertaking to disseminate any updates or revisions to any forward-looking statement contained herein to reflect any change in its expectation with regard thereto or any change in events, conditions or circumstances on which any such statement is based. Due to various risks and uncertainties, actual events or results or the actual performance of the Fund may differ materially from those reflected or contemplated in such forward-looking statements. Limited Partners are cautioned not to place undue reliance on such statements.

THE FOREGOING LIST OF RISK FACTORS AND CONFLICTS OF INTEREST DOES NOT PURPORT TO BE A COMPLETE EXPLANATION OF THE RISKS INVOLVED IN THIS OFFERING. PROSPECTIVE INVESTORS ARE URGED TO READ THIS ENTIRE MEMORANDUM BEFORE DETERMINING TO INVEST IN THE FUND.

X. CERTAIN TAX AND ERISA CONSIDERATIONS

IN ACCORDANCE WITH U.S. TREASURY REGULATIONS GOVERNING PRACTICE BEFORE THE INTERNAL REVENUE SERVICE (CIRCULAR 230), LEGAL COUNSEL TO THE FUND HEREBY INFORMS INVESTORS THAT (A) THE INFORMATION BELOW (OR OTHERWISE CONTAINED IN THIS DOCUMENT) IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED, BY THE INVESTORS FOR THE PURPOSE OF AVOIDING PENALTIES THAT THE INTERNAL REVENUE SERVICE (THE "IRS") MAY ATTEMPT TO IMPOSE ON AN INVESTOR, (B) THE INFORMATION WAS WRITTEN TO SUPPORT THE PROMOTION OR MARKETING OF THE TRANSACTION OR MATTERS ADDRESSED BY THE WRITTEN INFORMATION, AND (C) INVESTORS SHOULD SEEK TAX ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.

CERTAIN U.S. FEDERAL INCOME TAX CONSIDERATIONS

The following is a brief summary of certain U.S. federal income tax considerations that may be relevant to an investment in the Fund. This summary does not contain a comprehensive discussion of all U.S. federal income tax consequences that may be relevant to a Partner in view of that Partner's particular circumstances or (unless otherwise indicated) to certain Partners subject to special treatment under U.S. federal income tax laws — such as regulated investment companies, personal holding companies, brokers or dealers in securities, banks and certain other financial institutions, tax-exempt organizations, trusts, and insurance companies — nor does it address any state, estate, local, foreign, or other tax consequences of an investment in the Fund, except as otherwise provided herein. This summary is based on the assumptions that (i) each Partner (and each of its beneficial owners, as necessary under U.S. federal income tax withholding and backup withholding rules) will provide all appropriate certifications to the Fund in a timely fashion to minimize withholding (or backup withholding) on each Partner's distributive share of the Fund's gross income and (ii) each Partner will hold its Limited Partner Interest in the Fund as a capital asset for U.S. federal income tax purposes. Each prospective investor should also note that, except as otherwise provided herein, this summary does not address the interaction of U.S. federal tax laws and any income or estate tax treaties between the U.S. and any other jurisdiction.

No assurance can be given that the IRS will concur with the tax consequences set forth below. Each prospective investor is advised to consult its own tax counsel as to the specific U.S. federal income tax consequences of an investment in the Fund and as to applicable foreign, state, estate, and local taxes.

General Matters

Classification of the Fund - Pursuant to applicable U.S. Treasury Regulations, the Fund will be treated as a partnership, rather than a corporation, for U.S. federal income tax purposes unless the Fund affirmatively elects to be treated as a corporation for such purposes. The General Partner has no intention of making such an election on behalf of the Fund and does not anticipate any circumstances under which such an election would be made. In certain cases under Section 7704 of the Internal Revenue Code of 1986, as amended (the "Code"), a partnership that is classified as a "publicly traded partnership" may be taxed as a corporation for U.S. federal income tax purposes. The following discussion is based on the assumption that the Fund will not be treated as a "publicly traded partnership."

Treatment of U.S. Partners and Non-U.S. Partners - The discussion below addresses separately certain U.S. federal income tax matters relevant to U.S. Partners and Non-U.S. Partners. For purposes of this discussion, the term "U.S. person" generally means any U.S. citizen or resident individual, any corporation, limited liability company, or partnership organized under U.S. law, any estate (other than an estate the income of which, from sources outside the U.S. that is not effectively connected with a trade or business within the U.S., is not includible in its gross income for U.S. federal income tax purposes), and any trust if a court within the U.S. is able to exercise primary supervision over the administration of the trust and one or more U.S. persons have the authority to control all substantial decisions of the trust. The term "U.S. Partner" means any partner that is a U.S. person and, unless the context otherwise requires, includes any U.S. person that holds an equity interest in the Fund through one or more partnerships or other entities treated as transparent for U.S. federal income tax purposes. The term "Non-U.S. Partner" means a Partner that is not a U.S. person.

Taxation of Fund Operations Generally - As a partnership, the Fund will not pay U.S. federal income taxes, but each U.S. Partner will be required to report that Partner's distributive share (whether or not distributed) of the Fund's income, gains, losses, deductions and credits of the character specified in Section 702 of the Code. It is possible that the U.S. Partners could incur U.S. federal income tax liabilities without receiving from the Fund sufficient distributions to defray such tax liabilities. The Fund's taxable year will be the calendar year, or such other period as required by the Code. Tax information will be delivered to all Partners on an annual basis to enable the Partners to complete their tax returns.

Election to Adjust Basis of Fund Assets - Under the principal agreements relating to the Fund and Section 754 of the Code, the General Partner will have the authority to elect to adjust the basis of the Fund's assets (commonly referred to as "Section 754 adjustments") in connection with certain distributions made by the Fund to Partners or certain transfers of Limited Partner Interests in the Fund. Although the General Partner has no present intention of making an election on behalf of the Fund under Section 754 of the Code, Section 754 adjustments may nevertheless be mandatory under certain circumstances and could affect the amount of a Partner's allocations (for U.S. federal income tax purposes) of gain or loss recognized by the Fund on a disposition of its assets.

The General Partner also will have the authority under the principal agreements relating to the Fund to elect to treat the Fund as an "electing investment partnership" and, as a result, potentially avoid making Section 754 adjustments that otherwise would be mandatory with respect to certain transfers of Limited Partner Interests in the Fund. Such election, however, may result in the disallowance (for U.S. federal income tax purposes) of certain losses allocated by the Fund to transferees of Limited Partner Interests in the Fund. It is possible, however, that the Fund will not be able to qualify as an electing investment partnership.

The General Partner will have the authority to require any Partner engaging in a transaction that requires a Section 754 adjustment (for example, a transfer of the Partner's Limited Partner Interest) to bear the ongoing administrative and other costs incurred by the Fund or its Partners in connection with these basis adjustment rules. These costs, which could be significant, may be charged to a Partner without regard to whether the General Partner made either of the elections described above on behalf of the Fund. Furthermore, each Partner will be required to provide the Fund with any information necessary to allow the Fund to comply with its obligations to make Section 754 adjustments and/or its obligations as an electing investment partnership.

Tax-Exempt U.S. Partners

Unrelated Business Taxable Income - Under the terms of the principal agreements relating to the Fund, the General Partner will be required to use reasonable best efforts to conduct the affairs of the Fund in a manner that does not cause any tax-exempt U.S. Partner to recognize any "unrelated business taxable income" within the meaning of Section 512 of the Code; provided, however, that the General Partner may cause the Fund to borrow on a short-term basis and may guarantee the indebtedness of any portfolio company. The General Partner's undertaking will be deemed satisfied with respect to the making, holding or disposing of any portfolio investment if the tax-exempt U.S. Partners are given the opportunity to (or if all Limited Partners are otherwise required to) hold their proportionate shares of such portfolio investment directly or indirectly through an alternative investment vehicle treated as a corporation for U.S. federal income tax purposes. Notwithstanding this undertaking, it is possible that the Fund could realize income which would constitute unrelated business taxable income, and in that event each tax-exempt U.S. Partner would be subject to U.S. federal income tax on its share of such income and may be required to file a U.S. federal income tax return with respect to such income.

Taxable U.S. Partners

Limitations on Allowable Deductions - Under Section 67 of the Code, U.S. taxpayers who are individuals may deduct certain miscellaneous expenses (e.g., investment advisory fees, tax preparation fees, and unreimbursed employee expenses such as the cost of subscriptions to professional journals) only to the extent that these deductions exceed, in the aggregate, 2% of the taxpayer's adjusted gross income. Further, Section 68 of the Code disallows certain deductions otherwise allowable to taxpayers who are individuals; the amount disallowed varies based on the taxpayer's adjusted gross income. Part or all of the Fund's expenses allocated to any U.S. Partner who is an individual (including that Partner's share of the management fee payable to the Fund's Management Company) may be disallowed under these provisions, although tax-exempt U.S. Partners will generally not be affected. Finally, certain expenses (including the fees and expenses of placement agents, if any) incurred in connection with the offer and sale of the Limited Partner Interests are not deductible by any U.S. Partner. If the Management Company or an affiliate pays the fees or expenses of any placement agent, a corresponding portion of the Fund's expenses attributable to payments or accruals of the management fee is likely to constitute a nondeductible syndication expense.

Surtax on Unearned Income - Section 1411 of the Code generally imposes a 3.8% surtax on the "net investment income" of certain U.S. Partners who are citizens or resident aliens, and on the undistributed "net investment income" of certain U.S. estates and trusts. Among other items, "net investment income" generally would include a U.S. Partner's allocable share of the Fund's net gains and certain other income such as interest and dividends, less deductions allocable to such income. In addition, "net investment income" may include gain from the sale, exchange or other taxable disposition of an interest in the Fund, less certain deductions. U.S. Partners potentially subject to the surtax should consult their own advisors concerning its potential applicability to their individual circumstances.

***Passive Foreign Investment Companies* -** A portfolio investment by the Fund in a non-U.S. corporation that is classified as a "passive foreign investment company" ("PFIC") will cause taxable U.S. Partners to be subject to taxation under Sections 1291 through 1298 of the Code. In general, a non-U.S. corporation will be classified as a PFIC if 75% or more of its gross income constitutes "passive income" — generally, interest, dividends, royalties, rent and similar income, and gains on the disposition of assets that generate such income — or 50% or more of its assets (by value or, in certain situations, by adjusted tax bases) produce passive income or are held for the production of such income. Under the PFIC rules, gain attributable to a disposition of PFIC stock, as well as income attributable to certain "excess distributions" with respect to that PFIC stock, is allocated ratably over the shareholder's holding period for the stock. Gain allocated under this rule to (i) the year in which the shareholder disposes of the PFIC stock and (ii) any year prior to the time the foreign corporation first satisfied the PFIC income or assets test, as well as income attributable to any excess distribution on PFIC stock allocated to those years, is subject to tax (as ordinary income) at the U.S. federal income tax rates applicable to the shareholder for the year in which the disposition occurs. Disposition gain attributable to years included in the shareholder's holding period — other than those described in the preceding clauses (i) and (ii) — and income attributable to excess distributions allocated to each such other year is subject to tax (as ordinary income) at the maximum U.S. federal income tax rate applicable to the shareholder for the year in which the income is treated as realized, and also to an interest-like charge on the shareholder's "deferred" payment of this tax liability that accrues generally from the year of deemed realization through the due date of the shareholder's U.S. federal income tax return for the year of disposition or distribution (determined without regard to extensions). A U.S. Partner effectively will be treated as a U.S. shareholder with respect to its proportionate share of any PFIC stock owned by the Fund. If, however, that PFIC is also a "controlled foreign corporation" in which the Fund is a "United States Shareholder" (as defined below), the PFIC rules generally will be superseded by the rules discussed below dealing with controlled foreign corporations. The PFIC rules generally should not affect tax-exempt U.S. Partners.

The PFIC rules are highly technical and it is possible that a non-U.S. corporation in which the Fund makes an investment will be classified as a PFIC. If the Fund invests in the stock of a portfolio company classified as a PFIC, and that company agrees to provide the Fund and, if necessary, the IRS with certain financial information, the Fund may elect to treat that company as a "qualified electing fund" ("QEF"). If the Fund holds stock of a non-U.S. corporation with respect to which a QEF election has been made for the first taxable year in the Fund's holding period for which the non U.S. corporation is a PFIC, each U.S. Partner will be subject to tax currently on its proportionate share of certain earnings and net capital gain of that non-U.S. corporation — regardless of whether that corporation actually distributes cash or other property to the Fund — but generally will not be subject to the tax regime described in the preceding paragraph with respect to its investment in that corporation. Although the maximum rate of tax imposed on certain dividends is currently 20%, this rate does not apply to dividends paid or deemed paid by PFICs. A QEF election generally will not result in current inclusion of the PFIC's earnings for any year in which the PFIC has no net ordinary earnings and no net capital gain. Alternatively, if such PFIC stock is publicly traded, the Fund may be eligible to value the stock annually on a "mark-to-market" basis so that the Fund may treat any resulting gain or loss as ordinary income or loss to avoid the PFIC tax.

As noted above, the PFIC rules (including the rules pertaining to QEF elections) generally should not affect tax-exempt U.S. Partners.

The Fund cannot predict with any certainty at this time whether any non-U.S. portfolio company in which the Fund invests may be subject to the PFIC regime, whether a timely QEF election can or will be made, or the effect or availability of any applicable elections made by the Fund. The rules applicable to PFICs are complex, and the foregoing summary of U.S. federal income taxation of U.S. Partners indirectly owning an interest in a PFIC is general in nature. It is possible that U.S. Partners may be subject to tax currently under the PFIC regime on their proportionate shares of certain earnings of a non-U.S. corporation in which the Fund holds an interest and/or may incur nondeductible interest-like charges on tax liability deferred under the PFIC regime without receiving from the Fund distributions sufficient to satisfy any such obligations.

In addition to the PFIC rules discussed above, a U.S. person that is a shareholder of a PFIC may be required to file an annual information report and/or applicable tax forms with the IRS.

Controlled Foreign Corporations - Under Sections 951 through 957 of the Code, special rules apply to U.S. persons who own, directly or indirectly and applying certain attribution rules, 10% or more of the total combined voting power of all classes of stock of a non-U.S. corporation (each, a "United States Shareholder") that is a "controlled foreign corporation" ("CFC"). For this purpose, the Fund will be treated as a United States Shareholder of any foreign corporation in which the Fund's share ownership reaches this 10% threshold. A non-U.S. corporation generally will be a CFC for a taxable year if United States Shareholders collectively own more than 50% of the total combined voting power or total value of the corporation's stock on any day during such taxable year. United States Shareholders of a CFC generally must include in their gross income for U.S. federal income tax purposes their pro rata shares of certain earnings and profits of the CFC. Further, under Section 1248 of the Code, if a U.S. person sells or exchanges stock of a non-U.S. corporation and that person is or was a United States Shareholder at any time during the five-year period ending on the date of such sale or exchange during which that non-U.S. corporation was a CFC, that U.S. person generally will be required to treat a portion of the gain recognized upon such sale or exchange as a dividend to the extent of the earnings and profits of the CFC attributable to such stock. Under U.S. federal income tax rules, the Fund itself is a U.S. person and, if the Fund becomes a United States Shareholder of a CFC, taxable U.S. Partners (i) will be required to report and pay tax currently on their shares of the CFC's earnings and profits attributable to the Fund that are taxable to its United States Shareholders under the CFC rules, and (ii) will be subject to the Section 1248 recharacterization rule described above. In addition, if the Fund is a United States Shareholder of a CFC and a U.S. Partner disposes of its Limited Partner Interest, that Partner generally will recognize income under Section 751 of the Code equal to its distributive share of the Section 1248 income that would have been triggered if the Fund had sold its interest in the CFC at fair market value. The maximum rate of tax imposed on certain dividend income and certain long-term capital gains attributable to dispositions of securities generally is 20%, so that a recharacterization of gain under Section 1248 might not increase that U.S. Partner's U.S. federal income tax liability. In addition, income of a CFC subject to income tax in a country other than the U.S. at an effective rate greater than 90% of the maximum U.S. corporate income tax rate is not taxable to a United States Shareholder under the CFC rules if the United States Shareholder so elects.

The rules applicable to CFCs are complex, and the foregoing summary of the U.S. federal income taxation of U.S. Partners indirectly owning an interest in a CFC is general in nature. The General Partner cannot provide any assurance that the Fund's portfolio companies will not be CFCs. The CFC rules, however, generally should not affect tax-exempt U.S. Partners.

U.S. Foreign Tax Credits - The Fund may make investments in entities that are formed and operating under the laws of countries other than the United States. The countries in which these entities are organized and operate may impose taxes on the income of, and distributions or other payments made by, these entities. In addition, the Fund and/or the Partners may be required to file tax or information returns in such non-U.S. jurisdictions. U.S. Partners may be entitled, under certain circumstances, to a reduced rate of non-U.S. tax on their shares of such income or distributions under tax treaties between the United States and the non-U.S. jurisdictions imposing such tax, or may, in certain circumstances, be entitled under such treaties to file tax returns in such jurisdictions and claim refunds of any amounts of non-U.S. tax over-withheld.

Subject to applicable limitations on foreign tax credits, a U.S. Partner that is subject to U.S. federal income taxation generally should be entitled to elect to treat foreign taxes withheld from such Partner's share of the Fund's dividend and interest income as foreign income taxes eligible for credit against such Partner's U.S. federal income tax liability. Similarly, each U.S. Partner's share of any foreign taxes which may be imposed on capital gains or other income realized by the Fund generally should be treated as creditable foreign income taxes. Capital gains realized by the Fund, however, may be considered to be from sources within the U.S., which may effectively limit the amount of foreign tax credit allowed to the U.S. Partner. Other complex tax rules may also limit the availability or use of foreign tax credits, depending on each U.S. Partner's particular circumstances. Because of these limitations, U.S. Partners may be unable to claim a credit for the full amount of their proportionate shares of any foreign taxes paid by the Fund. U.S. Partners that do not elect to treat their shares of foreign taxes as creditable generally may claim a deduction against U.S. taxable income for such taxes (subject to applicable limitations on losses and deductions). Foreign tax credits or deductions generally will not provide any benefit to tax-exempt U.S. Partners unless such Partners' distributive shares of the income or gains on which the related foreign income taxes are imposed constitute "unrelated business taxable income" and certain other conditions are satisfied. However, since the availability of a credit or deduction depends on the particular circumstances of each U.S. Partner, Partners are advised to consult their own tax advisors.

Foreign Currency Issues - A U.S. Partner's distributive share of profits or losses realized by the Fund on the conversion of U.S. dollars into non-U.S. currency, or of non-U.S. currency into U.S. dollars, generally will be treated as ordinary income or loss rather than capital gain or loss. Further, if the Fund acquires, or becomes the obligor under, a debt instrument or enters into certain other transactions, any of which is denominated in terms of a currency other than the U.S. dollar, fluctuations in the value of that currency relative to the U.S. dollar generally will result in foreign currency gain or loss realized by the Fund and will be included in the U.S. Partners' distributive shares of Fund profits or losses as U.S.-source ordinary income or loss rather than capital gain or loss.

U.S. Reporting by U.S. Partners That Are Owners of Non-U.S. Entities - U.S. tax rules impose information reporting requirements on U.S. persons that own, either directly or indirectly under stock attribution rules, more than certain threshold amounts of stock in a foreign corporation; these persons must disclose, among other things, various transactions between themselves and those foreign corporations. For purposes of these information reporting requirements, stock ownership is determined with regard to certain stock attribution rules, and each U.S. Partner is treated as owning part or all of the stock owned directly or indirectly by the Fund. Similar reporting requirements apply to United States persons that (i) own, directly or indirectly, more than certain threshold amounts of certain foreign financial assets including, but not limited to stocks, securities and partnership interests in non-U.S. entities or (ii) contribute, in their capacity as Partners, more than a certain threshold amount to a non-U.S. partnership during a 12-month period. In certain circumstances, these rules may require U.S. Partners to file reports annually. U.S. Partners generally will be responsible for satisfying these information reporting requirements.

Non-U.S. Partners

U.S. Trade or Business Issues - Under the terms of the principal agreements relating to the Fund, the General Partner will be required to use commercially reasonable efforts to conduct the affairs of the Fund in a manner that limits the Fund's operations to investing and other related activities which, in the aggregate, would not cause the Fund to be treated as engaged in the conduct of a trade or business in the U.S. The General Partner's undertaking will be deemed satisfied with respect to the making, holding or disposing of any portfolio investment if the Non-U.S. Partners are given the opportunity to (or if all Limited Partners are otherwise required to) hold their proportionate shares of such portfolio investment directly or indirectly through an alternative investment vehicle treated as a corporation for U.S. federal income tax purposes. Notwithstanding this undertaking, it is possible that the activities of the Fund and the contractual arrangements into which it enters could cause the Fund to be treated as engaged in the conduct of a trade or business in the U.S.

Provided that the Fund is not engaged in the conduct of a U.S. trade or business, the U.S. federal income tax liability of a Non-U.S. Partner with respect to that Partner's Limited Partner Interest generally will be limited to withholding tax on certain gross income from U.S. sources generated by the Fund as long as the Non-U.S. Partner undertakes no activities in the U.S. (determined without regard to its investment in the Fund) that would cause that Partner to be engaged in the conduct of a U.S. trade or business, and, unless otherwise indicated, the following discussion of the U.S. federal income tax treatment of Non-U.S. Partners is based on that assumption.

Further, if the Fund withholds and remits the proper amounts to the U.S. government, Non-U.S. Partners that are individuals or corporations will not be required to file U.S. federal income tax returns or pay additional U.S. federal income taxes solely as a result of their investment in the Fund (though Non-U.S. Partners treated as trusts for U.S. federal income tax purposes are subject to special rules). If the Fund is not engaged in the conduct of a U.S. trade or business, Non-U.S. Partners' shares of income and gains from sources other than the U.S. (e.g., interest or dividends paid by non-U.S. portfolio companies and gains realized on the disposition of securities of those companies) will not be subject to U.S. federal income tax.

If it were ultimately established that the Fund is engaged in a U.S. trade or business, the Fund generally would be required to withhold and remit to the U.S. government a percentage of the Fund's net income and gains that are both effectively connected with that trade or business and allocated to Non-U.S. Partners, and would be liable for interest and penalties with respect to amounts which were not so withheld. The relevant withholding percentage is the maximum U.S. federal income tax rate for individuals or corporations, as applicable. In addition, Non-U.S. Partners generally would be required to file U.S. federal income tax returns and pay tax in respect of their shares of the Fund's effectively connected income including capital gains, but would be allowed a credit against U.S. federal income tax liability for amounts withheld by the Fund on their behalf. Non-U.S. Partners which are non-U.S. corporations might also be subject to a "branch profits" tax on certain earnings of the Fund deemed to have been repatriated to those Partners.

Treatment of Interest and Dividends from U.S. Sources - Certain categories of investment income from U.S. sources realized by the Fund, such as dividends and interest, generally will be subject to U.S. income tax withholding, at a 30% rate on the gross amount of that income, when included in the distributive shares of Non-U.S. Partners. A Non-U.S. Partner whose distributive share of such income is subject to U.S. withholding tax may be able to claim an exemption or a reduced rate of withholding under a tax treaty or convention between the U.S. and that Partner's country of residence by providing appropriate documentation regarding that Partner's residence for tax purposes and its satisfaction of any conditions imposed by the treaty. A Non-U.S. Partner resident in a jurisdiction with which the U.S. has a tax treaty, however, will not be entitled to the benefits of that treaty with respect to that Non-U.S. Partner's distributive share of the Fund's income and gains unless the Fund is treated as fiscally transparent under the law of that non-U.S. jurisdiction and certain other conditions are satisfied. Finally, in order to claim the benefits of a tax treaty to reduce U.S. withholding tax on U.S.-source interest and dividends paid by corporations that are not actively traded, a Non-U.S. Partner — and any direct or indirect equity owner of a Non-U.S. Partner seeking treaty benefits for itself because the Non-U.S. Partner is considered fiscally transparent in that equity owner's jurisdiction — generally will be required to obtain a U.S. taxpayer identification number from the IRS and may be required to provide that number and certain other documentation to the Fund. Other exemptions may be available for certain types of interest income.

Treatment of the Fund's Capital Gains from U.S. Sources - Under current U.S. law, in general, capital gains attributable to sales by the Fund of the securities of U.S. corporations will not be subject to U.S. federal income taxation or tax withholding when allocated to a Non-U.S. Partner unless that Partner is an individual who is present in the U.S. for 183 days or more during the taxable year in which such gains are realized and certain other conditions are satisfied.

This general rule does not apply to gains attributable to a U.S. trade or business or gains attributable to dispositions of securities of any "United States real property holding corporation" ("USRPHC"), defined in Section 897 of the Code as, in general, a company with 50% or more of the fair market value of its business assets consisting of interests in U.S. real estate and related assets. Capital gains attributable to sales by the Fund of the securities of a U.S. corporation that is a USRPHC (other than debt securities with no equity component) may be subject to U.S. income tax, collected initially by withholding, to the extent allocated to any Non-U.S. Partner. Non-U.S. Partners would also be required to file U.S. federal income tax returns, and might be liable for U.S. tax in excess of the amount collected by withholding. Similarly, Non-U.S. Partners could become subject to U.S. federal income tax and tax return filing obligations, as a result of transfers of their Limited Partner Interests at a time when the Fund owned stock of any U.S. corporation that is a USRPHC, although certain exceptions may apply. Even if a company in which the Fund invests is not a USRPHC at the time of such investment, such company subsequently may become a USRPHC.

Currency Conversion Issues - Non-U.S. Partners (like other Partners) will be required to make their capital contributions to the Fund in U.S. dollars, and any cash distributions made by the Fund will be made in U.S. dollars. Profits or losses realized by Non-U.S. Partners on the conversion of other currencies into U.S. dollars, or of U.S. dollars into other currencies, will neither be reflected in the capital accounts of the Partners nor affect the amounts distributable by the Fund to its Non-U.S. Partners.

Withholding on Payments to Certain Foreign Entities - Sections 1471 through 1474 of the Code would generally impose a withholding tax of 30% on certain gross amounts of income not effectively connected with a U.S. trade or business paid to certain foreign entities, unless certain requirements are satisfied. Amounts subject to withholding tax under these rules generally include gross U.S.-source dividend and interest income paid on or after July 1, 2014, as well as gross proceeds from the sale of property that produces U.S.-source dividend or interest income paid on or after January 1, 2017. To avoid withholding under these rules, Non-U.S. Partners that are subject to these rules will generally be obligated to comply with certain information reporting and disclosure requirements, including, in certain cases, entering into an agreement with the IRS. Non-U.S. Partners are encouraged to consult their own tax advisors regarding the possible application of Sections 1471 through 1474 of the Code to their investment in the Fund.

Other Tax Matters

Certain State and Local Tax Consequences - State and local taxing jurisdictions may impose income taxes and estate, inheritance and intangible property taxes on income from, or an investment in, the Fund. These tax laws may differ substantially from the U.S. federal tax laws. As a result of participating in the Fund, a Partner may be required to file tax returns with, and pay taxes to, any state or local jurisdiction in which the Fund does business (or is deemed to do business from investing a portion of its commitments in operating businesses treated as tax transparent for U.S. federal income tax purposes). A Partner's distributive share of the Fund's taxable income, gain, loss, deduction and credit is normally included in the income reported to the state and local jurisdiction(s) in which the Partner is a resident or does business. Investors should consult their own tax advisors about state and local taxes.

Basis for Description of Tax Consequences - The description of U.S. tax consequences set forth above is based on the provisions of the principal agreements relating to the Fund that the General Partner expects will be adopted, existing provisions of the Code, existing and proposed U.S. Treasury Regulations, existing administrative interpretations and court decisions, and certain assumptions. Future legislation, U.S. Treasury Regulations, administrative interpretations or court decisions could significantly change these authorities. Any such change could have retroactive application and therefore could apply to transactions that have taken place before such change occurs. In addition, some of the issues discussed above have not been addressed by administrative authorities or resolved by the courts. Accordingly, no assurance can be given that the IRS will agree with the description of the U.S. federal income tax consequences described above. No rulings have been or will be requested from the IRS. Furthermore, any changes in the principal agreements relating to the Fund or the operations of the Fund could affect the tax consequences described above.

Consultation with Tax Advisors **-** The description of U.S. tax matters set forth above is not intended as a substitute for careful tax planning. It does not address all of the U.S. federal income tax consequences to investors in the Fund, and does not address any of the foreign, state, local, estate or other tax consequences of such investment to any investor, except as otherwise specifically provided. Each prospective investor in the Fund is solely responsible for all tax consequences to that person or entity of an investment in the Fund. Each prospective investor is advised to consult its own tax counsel as to the U.S. federal income tax consequences attributable to acquiring, holding and disposing of an Limited Partner Interest and as to applicable foreign, state, local, estate or other taxes. The effect of existing U.S. income tax laws and treaties, the tax laws of other jurisdictions to which an investor may be subject, and possible changes in such laws and treaties (including proposed changes which have not yet been adopted) will vary with the particular circumstances of each investor.

CERTAIN ERISA CONSIDERATIONS

ERISA governs the investment of assets of ERISA Plans that may be investors, directly or indirectly, in the Fund. ERISA, the regulations under ERISA issued by the United States Department of Labor (the "DOL") and opinions and other authority issued by the DOL and the courts provide guidance that should be considered by fiduciaries of ERISA Plans prior to investing in the Fund.

The following discussion of certain ERISA considerations is based on statutory authority and judicial and administrative interpretations as of the date hereof and is designed only to provide a general understanding of the basic issues. Accordingly, this discussion should not be considered legal advice and the trustees and other fiduciaries of each ERISA Plan are encouraged to consult their own legal advisors on these matters.

Fiduciary Duty of Investing Plans

A fiduciary considering investing assets of an Employee Plan ("plan assets") in the Fund should consult its legal adviser before making such an investment. Before authorizing an investment in the Fund, any such fiduciary should, after considering the Employee Plan's particular circumstances, be satisfied that the investment of such plan assets in the Fund is appropriate under the fiduciary standards of ERISA, including standards with respect to prudence, diversification and compliance with the governing documents of the Employee Plan and its related trust and the prohibited transaction provisions of ERISA and the Code.

Plan Assets

ERISA and the regulation issued by the DOL at 29 C.F.R. § 2510.3-101, as modified or deemed to be modified by ERISA (the "Plan Assets Regulation"), define the term "plan assets" as applied to entities in which a plan invests, directly or indirectly, such as the Fund. The Plan Assets Regulation provides that when an ERISA Plan acquires an equity interest in an entity, and such equity interest is neither a publicly offered security nor a security issued by an investment company registered under the Investment Company Act, the assets of the ERISA Plan include not only the equity interest, but also include an undivided interest in the underlying assets of the entity, unless an exception to this general rule applies.

Exceptions Under the Plan Assets Regulation

The Plan Assets Regulation provides several exceptions to the general rule of plan asset treatment. Pursuant to one such exception, the assets of certain entities, such as the Fund, will not be treated as plan assets if the entity is operated as a "venture capital operating company" within the meaning of the Plan Assets Regulation ("VCOC"). Generally, for an entity to qualify as a VCOC, at least fifty percent (50%) of its assets (excluding short-term investments made pending long-term commitments or distribution to investors) valued at cost must be invested in (a) "operating companies" with respect to which the entity has the direct contractual right to participate substantially in, or to substantially influence the conduct of, the management of the operating company and the entity must actually exercise such management rights with respect to one or more such operating companies in the ordinary course of its business, or (b) "derivative investments" (as defined in the Plan Assets Regulation) (the "Asset Test"). For the purposes of qualifying as a VCOC, an "operating company" is defined as an entity that is primarily engaged, directly or through a majority owned subsidiary or subsidiaries, in the production or sale of a product or service other than the investment of capital, and includes a "real estate operating company" as defined in the Plan Assets Regulation (but does not include another VCOC). Determination as to whether an entity qualifies as a VCOC is made at the time when the entity makes its first long-term investment (other than short-term investments made pending long-term commitments) and thereafter during a ninety-day annual valuation period each year, the first day of which shall begin no later than the anniversary of the entity's first long-term investment. In order for an entity to continue to qualify as a VCOC, the entity must meet the Asset Test on at least one day during each such ninety-day annual valuation period. Special rules apply to any wind-up of a VCOC when it enters its "distribution period" as defined in the Plan Assets Regulation.

An additional exception applies when equity participation in the entity by benefit plan investors is not "significant." Equity participation in an entity by "benefit plan investors" (as defined in Section 3(42) of ERISA) is "significant" on any date if, immediately after the most recent acquisition or disposition of any equity interest in the entity, 25% or more of the value (in the aggregate) of any class of equity interests in the entity is held by "benefit plan investors." For purposes of the 25% test, the term "benefit plan investors" includes ERISA Plans, certain other retirement plans defined in and subject to Section 4975 of the Code (such as individual retirement accounts), and entities or accounts deemed to hold "plan assets" due to an investment in such entity or account by ERISA Plans or such other retirement plans (such as insurance company general accounts). For the purposes of calculating the 25% threshold under the Plan Assets Regulation, the value of any equity interest held by a person (other than a "benefit plan investor") who has discretionary authority or control with respect to the assets of the entity or that provides investment advice for a fee (direct or indirect) with respect to such assets (or an affiliate of such person) is disregarded.

The General Partner will use reasonable best efforts to conduct the affairs and operations of the Fund in such a manner so that the assets of the Fund will not be treated as "plan assets" of any

ERISA Plan for purposes of ERISA. In particular, the General Partner will use reasonable best efforts to either (i) limit investment in the Fund by "benefit plan investors" to a level that would not be considered "significant" under ERISA, or (ii) operate the Fund as a VCOC, or (iii) operate the Fund in compliance with any other then-available exception to the general rule of plan asset treatment. The General Partner has the authority to require a Limited Partner to withdraw from the Fund (in whole or in part) where the General Partner determines that such withdrawal is necessary to avoid having the Fund's assets deemed to be "plan assets" subject to ERISA or Section 4975 of the Code. Accordingly, the Fund is not expected to be deemed to be holding "plan assets" subject to ERISA at any time.

Reporting

Benefit plan investors may be required to report certain compensation paid by the Fund (or by third parties) to the Fund's service providers as "reportable indirect compensation" on Schedule C to the Form 5500 Annual Return (the "Form 5500"). To the extent any compensation arrangements described herein constitute reportable indirect compensation, any such descriptions are intended to satisfy the disclosure requirements for the alternative reporting option for "eligible indirect compensation," as defined for purposes of Schedule C to the Form 5500.

Additional Information

ERISA and its accompanying regulations are complex and, to a great extent, have not yet been interpreted by the courts or the administrative agencies. This discussion does not purport to constitute a thorough analysis of ERISA. Each prospective investor subject to ERISA should consult with its own legal counsel concerning the implications under ERISA of an investment in the Fund, and to confirm that such an investment will not constitute or result in a non-exempt prohibited transaction or any other violation of an applicable requirement under ERISA.

"Governmental plans" and certain "church plans", while not subject to the fiduciary responsibility and prohibited transaction provisions of ERISA, may nevertheless be subject to state or other federal laws that are substantially similar to the foregoing provisions of ERISA. Decision-makers for any such plans should consult with their counsel before making an investment in the Fund.

XI. CERTAIN LEGAL & REGULATORY CONSIDERATIONS

Securities Act of 1933

The Limited Partner Interests described herein will not be registered under the Securities Act in reliance upon the exemptions for transactions not involving a public offering. Each investor will be required to make certain representations to the Fund, including that such investor is an "accredited investor" within the meaning of Rule 501(a) under the Securities Act, that it is acquiring a Limited Partner Interest in the Fund for its own account, for investment purposes only and not with a view to resale or distribution, that it has received or has had access to all information it deems relevant to evaluate the merits and risks of an investment in the Fund and that it has the ability to bear the economic risk of an investment in the Fund. The Limited Partner Interests described herein will constitute "restricted securities" under the Securities Act and as such will be subject to certain restrictions on transferability. The Limited Partner Interests may not be transferred or sold unless the Limited Partner Interests have been registered under the Securities Act or an exemption from registration is available. It is not contemplated that registration under the Securities Act or other securities laws will ever be effected. The Limited Partner Interests are subject to further restrictions on transfer as described in the Partnership Agreement.

This Memorandum is not a public offering "prospectus" and does not purport to describe or otherwise address all material considerations relating to an investment in the Fund. Prior to making an investment, prospective investors and their advisors are invited to ask questions of, and obtain additional information from, the General Partner concerning the Limited Partner Interests described herein, the terms and conditions of the offering and any other relevant matters. Such information will be provided to the extent the General Partner possesses such information or can acquire it without unreasonable effort or expense.

Any subscription is subject to a determination by counsel to the Fund that the subscription is in compliance with applicable federal and state laws and regulations.

Investment Company Act of 1940

The Fund will not be registered as an investment company under the Investment Company Act pursuant to an exemption set forth in Section 3(c)(1) and/or Section 3(c)(7) of the Investment Company Act. The Fund will obtain appropriate representations and undertakings from all purchasers of Limited Partner Interests, including restrictions on transfer, to ensure that such purchasers meet the conditions of the exemption. Section 3(c)(7) of the Investment Company Act requires that each prospective purchaser be a "qualified purchaser" within the meaning of Section 2(a)(51) of the Investment Company Act. Information with respect to such requirements for "qualified purchaser" status will be included in the Fund's Subscription Agreement. The General Partner is not registered as a broker-dealer under the Exchange Act, or with the NASD, and is consequently not subject to certain record keeping and specific business practice provisions of the Exchange Act and the rules of the NASD.

Investment Advisers Act of 1940

Neither the Management Company nor the General Partner is currently registered as an investment adviser under the Advisers Act. By virtue of being exempt from the registration requirements of the Advisers Act, the Management Company and the General Partner are not subject to the performance fee restrictions and certain other restrictions contained in the Advisers Act, and the investors in the Fund will not be afforded the protections provided under the Advisers Act to clients of advisors that are registered under the Advisers Act. The General Partner, the Management Company or an affiliate thereof may in the future register as an investment adviser under the Advisers Act to the extent required under the Advisers Act.

To the maximum extent permitted by applicable law, the General Partner and the Partnership (together with their respective related persons) hereby disclaim any duties, obligations, or status as an advisor, finder, agent, broker or dealer on behalf or in respect of any person in connection with such person's actual or proposed investment in the Partnership.

Compliance With Anti-Money Laundering Requirements

In response to increased regulatory requirements with respect to the sources of funds used in investments and other activities, the General Partner may require prospective investors to provide documentation verifying, among other things, such investor's (and any of its beneficial owners') identities and source of funds used to purchase its Limited Partner Interest in the Fund. The General Partner may decline to accept a subscription if this information is not provided or on the basis of such information that is provided.

Each prospective investor and Limited Partner will be required to make representations that such prospective investor or Limited Partner is not a prohibited country, territory, individual or entity listed on the U.S. Department of Treasury Office of Foreign Assets Control ("OFAC") website and that it is not directly or indirectly affiliated with any country, territory, individual or entity named on an OFAC list or prohibited by any OFAC sanctions programs. Such prospective investor or Limited Partner will also represent that amounts contributed by it to the Fund were not directly or indirectly derived from activities that may contravene U.S. Federal, state or international laws and regulations, including, without limitation, anti-money laundering laws and regulations.

Requests for documentation and additional information may be made at any time during which an investor holds a Limited Partner Interest in the Fund. The General Partner will take such steps as it determines are necessary to comply with applicable law, regulations, orders, directives or special measures to implement anti-money laundering laws, which steps may include the forced sale or withdrawal of an Interest. In addition, the Fund could be required to disclose information pertaining to prospective investors subscribing for an interest to governmental, regulatory or other authorities or to financial intermediaries or engage in due diligence or take other related actions in the future.

Pay-to-Play Laws, Regulations and Policies

In light of recent scandals involving money managers, a number of states and municipal pension plans have adopted so-called "pay-to-play" laws, regulations or policies which prohibit, restrict or require disclosure of payments to (and/or certain contacts with) state officials by individuals and entities seeking to do business with state entities, including investments by public retirement funds. The SEC also has recently adopted rules that, among other things, prohibit an investment adviser from providing advisory services for compensation with respect to a government plan investor for two years after the adviser or certain of its executives or employees make a contribution to certain elected officials or candidates. If the Management Company, the General Partner, their employees or affiliates fail to comply with such pay-to-play laws, regulations or policies, such non-compliance could have an adverse effect on the Fund by, for example, providing the basis for the withdrawal of the affected government plan investor.

XIII. APPENDICES

Appendix 1

Listing of Investments by Fund

New Leaf Ventures II, L.P.

$ amounts in millions, as of March 31, 2014

Please refer to Endnotes I,J,K,L,M and N in this Appendix.

Company	Sector	Vintage Year	Total Cost	Realized Value	Unrealized Value	Total Value	Gross Multiple (Realized Portion)	Gross Multiple (Total)	Gross IRR
Realized or Partially Realized Investments									
Acadia Phamaceuticals, Inc.	Therapeutics	2012	$ 7.7	$ 19.4	$ -	$ 19.4	2.51	2.51	581.9%
Ambit Biosciences, Inc.	Therapeutics	2013	$ 10.4	$ 11.1	$ -	$ 11.1	1.06	1.06	13.1%
Array Biopharma Inc.	Therapeutics	2012	$ 9.0	$ 20.3	$ -	$ 20.3	2.25	2.25	74.0%
Audax Health Solutions, Inc.	Convergence	2011	$ 3.8	$ 12.5	$ 1.6	$ 14.1	-	3.68	105.6%
Chimerix, Inc.	Therapeutics	2011	$ 20.6	$ 27.0	$ 44.9	$ 71.9	3.07	3.50	57.7%
Epizyme, Inc.	Therapeutics	2013	$ 3.4	$ 6.8	$ -	$ 6.8	2.03	2.03	1583.0%
Glumetrics, Inc.	Diagnostics & Infrastructure	2008	$ 10.7	$ -	$ -	$ -	-	-	NM
Intercept Pharmaceuticals, Inc.	Therapeutics	2012	$ 10.5	$ 34.1	$ -	$ 34.1	3.24	3.24	323.6%
Kalidex Pharmaceuticals, Inc.	Therapeutics	2011	$ 2.4	$ 0.2	$ -	$ 0.2	0.07	0.07	-91.6%
MEI Pharma, Inc.	Therapeutics	2012	$ 9.0	$ 10.2	$ 35.8	$ 46.0	2.94	5.12	423.2%
Presidio Pharmaceuticals, Inc.	Therapeutics	2009	$ 11.0	$ -	$ -	$ -	-	-	NM
Synageva BioPharma	Therapeutics	2009	$ 10.4	$ 75.7	$ -	$ 75.7	7.30	7.30	103.3%
Worldheart, Inc.	Healthcare Devices	2008	$ 17.0	$ 1.8	$ -	$ 1.8	0.11	0.11	NM
Total Realized or Partially Realized Investments			**$ 125.9**	**$ 219.2**	**$ 82.3**	**$ 301.5**	**2.01**	**2.39**	**40.6%**
Advanced Cell Diagnostics, Inc.	Diagnostics & Infrastructure	2012	$ 9.0	$ -	$ 9.0	$ 9.0	-	1.00	-0.4%
Afferent Pharmaceuticals, Inc.	Therapeutics	2009	$ 11.2	$ -	$ 11.2	$ 11.2	-	1.00	0.0%
Altura Medical, Inc.	Healthcare Devices	2010	$ 10.7	$ -	$ 8.3	$ 8.3	-	0.77	-12.3%
AwarePoint Corporation	Convergence	2011	$ 12.8	$ -	$ 14.1	$ 14.1	-	1.10	5.7%
Calchan Holdings LTD	Therapeutics	2011	$ 5.2	$ -	$ -	$ -	-	-	NM
CardioKinetix, Inc.	Healthcare Devices	2011	$ 12.0	$ -	$ 12.0	$ 12.0	-	1.00	0.0%
Convergence Pharmaceuticals, Ltd	Therapeutics	2010	$ 7.4	$ -	$ 7.6	$ 7.6	-	1.03	1.0%
Durata Therapeutics, Inc.	Therapeutics	2009	$ 25.0	$ -	$ 40.8	$ 40.8	-	1.63	21.2%
iRhythm Technologies, Inc.	Convergence	2011	$ 11.1	$ -	$ 11.6	$ 11.6	-	1.04	1.6%
Karos Pharmaceuticals, Inc.	Therapeutics	2010	$ 7.6	$ 0.1	$ 7.5	$ 7.6	-	1.00	0.0%
Karus Therapeutics Ltd	Therapeutics	2012	$ 5.8	$ -	$ 5.8	$ 5.8	-	1.00	0.0%
Karyopharm Therapeutics, Inc.	Therapeutics	2013	$ 1.0	$ -	$ 4.2	$ 4.2	-	4.17	1638.7%
Kitcheck, Inc.	Convergence	2013	$ 3.7	$ -	$ 3.7	$ 3.7	-	1.00	0.0%
Neuronetics, Inc.	Healthcare Devices	2009	$ 20.3	$ -	$ 21.9	$ 21.9	-	1.08	2.0%
NY Digital Health, LLC	Convergence	2012	$ 0.4	$ -	$ 0.4	$ 0.4	-	1.00	0.1%
Oxford Immunotec	Diagnostics & Infrastructure	2009	$ 11.3	$ -	$ 27.1	$ 27.1	-	2.41	28.3%
Principia BioPharma, Inc.	Therapeutics	2011	$ 9.7	$ -	$ 9.7	$ 9.7	-	1.00	0.0%
Spiracur, Inc	Healthcare Devices	2009	$ 12.0	$ -	$ 8.5	$ 8.5	-	0.70	-8.4%
TigerText, Inc.	Convergence	2012	$ 4.6	$ 0.0	$ 5.6	$ 5.7	-	1.25	22.6%
Treato Pharma	Convergence	2013	$ 3.0	$ -	$ 3.0	$ 3.0	-	1.00	0.0%
Truveris, Inc.	Convergence	2012	$ 6.5	$ -	$ 6.5	$ 6.5	-	1.00	0.0%
Versartis, Inc.	Therapeutics	2011	$ 21.2	$ -	$ 93.6	$ 93.6	-	4.41	129.4%
Public Investments	Therapeutics	2011	$ 20.6	$ 13.1	$ 29.5	$ 42.6	-	2.07	42.5%
Total Unrealized Investments			**$ 232.1**	**$ 13.2**	**$ 341.4**	**$ 354.6**	**-**	**1.53**	**20.4%**
Total New Leaf Ventures II, L.P. Investments			**$ 358.0**	**$ 232.4**	**$ 423.7**	**$ 656.1**	**2.01**	**1.83**	**29.6%**

New Leaf Ventures I, L.P.

$ amounts in millions, as of March 31, 2014
Please refer to Endnotes I,J,K,L,M and N in this Appendix.

Company	Sector	Vintage Year	Total Cost	Realized Value	Unrealized Value	Total Value	Gross Multiple (Realized Portion)	Gross Multiple (Total)	Gross IRR
Realized or Partially Realized Investments									
Aesthetic Sciences Corporation	Healthcare Devices	2006	$ 4.1	$ -	$ -	$ -	-	-	NM
Artisan Pharma, Inc.	Therapeutics	2006	$ 10.8	$ -	$ -	$ -	-	-	NM
Aviir, Inc.	Diagnostics & Infrastructur	2007	$ 16.3	$ 0.9	$ -	$ 0.9	0.05	0.05	NM
Barrier Therapeutics, Inc.	Therapeutics	2006	$ 8.2	$ 6.4	$ -	$ 6.4	0.78	0.78	-11.8%
BioRelix, Inc.	Therapeutics	2007	$ 6.3	$ -	$ -	$ -	-	-	NM
Cerexa, Inc.	Therapeutics	2005	$ 8.0	$ 43.4	$ -	$ 43.4	5.42	5.42	197.3%
CN Therapeutics, Inc.	Therapeutics	2006	$ 0.1	$ -	$ -	$ -	-	-	NM
Interlace Medical, Inc.	Healthcare Devices	2005	$ 7.8	$ 67.3	$ 0.1	$ 67.4	8.62	8.64	84.4%
Oriel Therapeutics, Inc.	Therapeutics	2007	$ 11.1	$ 18.8	$ 12.2	$ 31.0	1.70	2.80	49.9%
Pearl Therapeutics, Inc.	Therapeutics	2007	$ 28.9	$ 72.3	$ 17.3	$ 89.6	2.50	3.10	33.1%
Proteogenix, Inc.	Diagnostics & Infrastructur	2007	$ 9.4	$ 0.8	$ -	$ 0.8	0.08	0.08	NM
Stromedix, Inc.	Therapeutics	2008	$ 10.7	$ 19.2	$ 22.5	$ 41.7	1.79	3.89	42.0%
Transcept Pharmaceuticals, Inc	Therapeutics	2005	$ 15.6	$ 7.1	$ -	$ 7.1	0.46	0.46	-11.5%
Total Realized or Partially Realized Investments			**$ 13.7**	**$ 236.2**	**$ 52.1**	**$ 288.3**	**1.72**	**2.10**	**27.5%**
Unrealized Investments									
Access Closure, Inc.	Healthcare Devices	2006	$ 24.7	$ -	$ 35.4	$ 35.4	-	1.43	6.1%
Concert Pharmaceuticals, Inc.	Therapeutics	2006	$ 6.2	$ -	$ 6.8	$ 6.8	-	1.11	1.5%
Direct Flow Medical, Inc.	Healthcare Devices	2005	$ 13.0	$ -	$ 20.2	$ 20.2	-	1.56	7.1%
IlluminOss Medical, Inc.	Healthcare Devices	2008	$ 10.1	$ -	$ 9.7	$ 9.7	-	0.97	-0.8%
Intarcia Therapeutics, Inc.	Therapeutics	2007	$ 36.9	$ -	$ 186.9	$ 186.9	-	5.06	39.9%
Relypsa, Inc.	Therapeutics	2007	$ 23.7	$ -	$ 61.8	$ 61.8	-	2.60	27.5%
ReShape Medical	Healthcare Devices	2006	$ 13.6	$ -	$ 13.7	$ 13.7	-	1.01	0.2%
Tioga Pharmaceuticals, Inc.	Therapeutics	2005	$ 19.6	$ -	$ 7.2	$ 7.2	-	0.37	-14.6%
VaxInnate, Inc.	Therapeutics	2006	$ 19.4	$ -	$ 19.6	$ 19.6	-	1.01	0.2%
Total Unrealized Investments			**$ 167.2**	**$ -**	**$ 361.4**	**$ 361.4**	**-**	**2.16**	**15.2%**
Total New Leaf Ventures I, L.P. Investments			**$ 304.5**	**$ 236.2**	**$ 413.5**	**$ 649.7**	**1.72**	**2.13**	**19.1%**

Sprout Capital VIII, L.P. (Healthcare Technology Portfolio)

$ amounts in millions, as of March 31, 2014
Please refer to Endnotes I,J,K,L,M and N in this Appendix.

Company	Sector	Vintage Year	Total Cost	Realized Value	Unrealized Value	Total Value	Gross Multiple (Realized Portion)	Gross Multiple (Total)	Gross IRR
All Investments									
Allos Therapeutics, Inc.	Therapeutics	1998	$ 3.5	$ 9.8	$ -	$ 9.8	2.83	2.83	47.6%
AviaHealth, Inc. (fka GoToMyDoc)	Convergence	2000	$ 2.0	$ 0.0	$ -	$ 0.0	0.02	0.02	-92.8%
Cephalon, Inc.	Therapeutics	1999	$ 5.1	$ 25.6	$ -	$ 25.6	5.01	5.01	293.2%
Charles River Laboratories	Diagnostics & Infrastructure	1999	$ 4.3	$ 22.7	$ -	$ 22.7	5.23	5.23	121.6%
Deltagen, Inc.	Therapeutics	1998	$ 19.9	$ 4.1	$ -	$ 4.1	0.20	0.20	-30.3%
eHealth, Inc.	Convergence	1999	$ 11.3	$ 20.3	$ -	$ 20.3	1.80	1.80	7.7%
Gantech International, Inc.	Therapeutics	1999	$ 2.8	$ -	$ -	$ -	-	-	NM
Keravision Inc.	Healthcare Devices	1998	$ 10.2	$ -	$ -	$ -	-	-	NM
Microban International, Ltd.	Diagnostics & Infrastructure	1999	$ 14.8	$ 39.7	$ -	$ 39.7	2.68	2.68	14.5%
Nuvelo, Inc. (fka Variagenics, Inc.)	Therapeutics	1999	$ 11.8	$ 24.8	$ -	$ 24.8	2.10	2.10	13.9%
NxStage Medical, Inc.	Healthcare Devices	1999	$ 17.8	$ 50.3	$ -	$ 50.3	2.83	2.83	14.2%
Phase Forward Incorporated	Convergence	1998	$ 9.0	$ 38.6	$ -	$ 38.6	4.31	4.31	22.4%
SGX, Inc.	Therapeutics	2000	$ 15.0	$ 1.6	$ -	$ 1.6	0.11	0.11	-35.3%
Skila, Inc.	Convergence	1998	$ 9.0	$ 0.0	$ -	$ 0.0	0.00	0.00	NM
Spotfire, Inc.	Convergence	1999	$ 9.9	$ 24.8	$ -	$ 24.8	2.50	2.50	12.7%
VascA, Inc.	Healthcare Devices	1999	$ 7.3	$ 0.1	$ -	$ 0.1	0.02	0.02	NM
VNUS Medical Technologies, Inc.	Healthcare Devices	1999	$ 3.8	$ 11.1	$ -	$ 11.1	2.90	2.90	12.7%
Total Sprout Capital VIII, L.P. (HCT) Investments			**$ 157.5**	**$ 273.7**	**$ -**	**$ 273.7**	**1.74**	**1.74**	**10.1%**

Methodology Used to Calculate Net Returns Numbers for Sprout Healthcare Technology Portfolios

Estimated net returns numbers for the managed healthcare portfolio of the Sprout funds are based on New Leaf's calculations of synthetic net returns. The synthetic net returns for the healthcare technology investments in each Sprout Fund are an estimate of what the net returns would have been for these investments, if they had been managed in a standalone healthcare technology venture capital fund structure rather than one set of investments as part of a larger, diversified venture capital fund. The synthetic net returns were computed assuming a fund size required to fund 100% of the total cost of the healthcare investments in each of the Sprout funds using both called and recycled capital, a management fee of 2% payable quarterly and a carried interest. The net return reflects reinvestment of certain proceeds, gains and other proceeds by the Sprout healthcare portfolio synthetic funds to the extent permitted under the partnership governing documents. A detailed example of the calculation is below.

> **Sprout IX**: Total actual HCT investments of $740M; 2% management fees, resulting in $120M of management fees and expenses from inception-to-date; 25% carried interest; Standalone fund size of $690M ($735M investments with cash recycling of 6%); Total realizations have been $1,375M and total remaining value is $50M. Assumes $130M in total carried interest to GPs already paid out; Yields Total Distributed to LPs of $1,075M ($1,375M - $120M fees - $130M carry - $50M recycling) / $690M = 1.56x; Yields Total Remaining to LPs of $50M / $690M = 0.07x

Appendix 3

PME+ Methodology

Public Market Equivalent ("PME+") is used to compare the net performance of each of the Sprout HC synthetic funds and NLV funds to the performance of a same size, hypothetical investment in a fund that tracked a public market index. The investments in the hypothetical public market index funds have identical cash inflow schedules and proportionately comparable cash outflow schedules. The cash outflow schedules are set so that the remaining equity value of the public equivalent fund is exactly equal to the remaining equity value of the benchmarked private equity fund at the end of the benchmarking period. The analysis is presented to illustrate the comparative returns a limited partner would have generated by investing in the hypothetical public market index fund at the same time and in the same amounts as had been invested in each of the NLV or Sprout (HC portion only) synthetic funds. The NLV or Sprout HC funds are presented as net, which includes the impact of management fees, expenses, and carried interest. The public market index funds do not have any impact of fees or carried interest. A more detailed description of the PME+ methodology used is available in: Rouvinez, Christophe. "Asset Class: Beating the Public Market." Private Equity International. January 2003. 26-28

Appendix 5

ENDNOTES

Except as otherwise expressly noted, all performance information contained herein, including rates of return, is as of March 31, 2014 and is unaudited. The performance information is based on the cumulative invested capital, cumulative cash dividends and realized and unrealized sales proceeds in portfolio companies. Where designated as "gross", the performance information is presented on a gross basis with regard to expenses and does not reflect deductions for any management fees, the general partner's carried interest or other expenses. Where designated as "net", the performance information is presented on a net basis after giving effect to management fees, the general partner's carried interest and other expenses. Please refer to Section III: "Summary of Historical Investment Performance" and the endnotes below for a more detailed description of the performance of the NLV-I, NLV-II and the Sprout Funds. An investment in the Fund does not represent an interest in any indicated investment or any investment portfolio of any related or other investment fund, including any investment or fund managed by the Fund Managers. Disclosure of past performance herein is for informational purposes only and is not indicative of future results.

[A] The financial data contained herein relating to the valuations and investment performance of NLV-I, NLV-II, the Sprout Funds and their investments (including the I.C. portfolio thereof) are estimates prepared by NLV as of March 31, 2014, and have not been audited. The vintage year of each fund represents the first year that an investment in a portfolio company was either committed to or funded. While NLV's valuations of unrealized investments are based on assumptions that NLV believes are reasonable under the circumstances, the actual realized returns on unrealized investments will depend on, among other factors, future operating results, the value of the assets and market conditions at the time of disposition, any related transaction costs and the timing and manner of the sale, all of which may differ from the assumptions on which the valuations used in the prior performance data contained herein are based. Accordingly, the actual realized returns on these unrealized investments may differ materially and adversely from the (assumed) returns indicated herein. Past performance is not indicative of future results. There can be no assurance that the Fund will achieve results comparable to those shown herein, will be able to avoid losses or will be able to achieve its investment objectives. Except as specifically noted, all performance information contained herein is on a "gross" basis before giving effect to management fees, the general partner's carried interest, taxes and other expenses, the application of which would reduce such prior performance and indicated rates of return. Except as otherwise indicated, performance information is for NLV-I, NLV-II and the Fund Managers' investments in the Sprout Funds. While the Fund Managers initiated, led, co-led, managed or were otherwise instrumental in the identification, negotiation, execution and/or management of these investments (as further described herein), other individuals, including individuals from Sprout Group with respect to the Sprout Funds, were involved in and assisted with these investments.

[B] Rates of return for public indices are provided for informational purposes only and do not reflect a basis for comparison for venture capital interests, as the market volatility, liquidity and other characteristics of venture capital investments are materially different from public indices. The S&P 500 Stock Index is an unmanaged market capitalization of 500 U.S. equities generally considered to be representative of U.S. stock market activity. The NASDAQ Composite Index measures all NASDAQ domestic and non-U.S. based common stocks listed on the NASDAQ Stock Market. The NASDAQ Biotechnology Index includes securities of NASDAQ-listed companies classified according to the Industry Classification Benchmark as either Biotechnology or Pharmaceuticals which also meet other eligibility criteria. The Dow Jones Industrial Average is an index that shows how 30 large, publicly owned companies based in the U.S. have traded during a standard trading session in the stock market.

[C] Data provided by Cambridge Associates at no charge. Cambridge U.S. VC healthcare data as of Q1'13. Where results on the Sprout Funds refer to net basis, it is the result of a methodology that adjusts the gross results for the healthcare technology investments for recycling, management fees, and carried interest so they can be compared to industry sources (e.g., Cambridge Associates) on a directly comparable basis. The methodology and assumptions used to adjust from gross to net basis is described in Appendix 2.

[D] The gross annual compound internal rate of return ("IRR") and gross multiple of invested capital as of March 31, 2014 are before giving effect to taxes, management fees, the general partner's carried interest and other expenses. The net IRR and net multiple of invested capital as of March 31, 2014 are after giving effect to management fees, the general partner's carried interest and other expenses. All IRRs presented are annualized and calculated on the basis of quarterly inflows and outflows of cash and unrealized values, assuming such inflows and outflows occurred as of quarter end and all remaining investments were sold at the current holding value through as of March 31, 2014. There can be no assurance that unrealized investments will be realized at the valuations shown.

[E] The results for the Sprout Funds represent results from the healthcare technology portion of the Sprout Funds, which represents between 8% and 65% of the cost basis of the investments of the funds taken as a whole. Healthcare technology means, collectively, the biopharmaceutical, medical device, and diagnostics and infrastructure sectors. See Appendix 2 for the Methodology Used to Calculate Net Return Numbers for Sprout Healthcare Technology Portfolios.

[F] **Net Distributed to Paid-in Capital ("DPI")**: Calculated based on (1) called capital of a fund (based on individual called capital percentages and fund sizes across multiple funds) and (2) distributed capital of a fund (based on aggregating individual funds distributed capital amounts, as calculated using DPI and called individual fund called amounts). For the purposes of this ratio for NLV-I and NLV-II, the "deemed contribution" of the general partner is included in the total amount of capital contributions made by the fund's partners.

[G] **(Distributed + Public) to Paid-in Capital**: Calculated based on (1) called capital of a fund (based on individual called capital percentages and fund sizes across multiple funds) and (2) distributed capital of a fund (based on aggregating individual funds distributed capital amounts, as calculated using DPI and called individual fund called amounts) plus the unrealized value of publicly traded securities based on the closing market price of the security. For the purposes of this ratio for NLV-I and NLV-II, the "deemed contribution" of the general partner is included in the total amount of capital contributions made by the fund's partners.

H **(Distributed + Liquid Public) to Paid-in Capital**: Calculated based on (1) called capital of a fund (based on individual called capital percentages and fund sizes across multiple funds) and (2) distributed capital of a fund (based on aggregating individual funds distributed capital amounts, as calculated using DPI and called individual fund called amounts) plus the unrealized value of freely tradable publicly traded securities based on the closing market price of the security. This is based on the assumption that NLV can trade out of 10% of daily trading volume over next 30 days based on last 30 days ADTV.

For the purposes of this ratio for NLV-I and NLV-II, the "deemed contribution" of the general partner is included in the total amount of capital contributions made by the fund's partners.

I **Realized Cost**: Represents the cost of investment attributable to the realized portion of such investment.

J **Total Cost**: Represents the overall cost of investment.

K **Realized Value**: Represents gross proceeds received from the sale of an underlying investment or group of investments.

L **Unrealized Value, Unrealized/(Public) or Unrealized/(Private)**: All private investments are fair value as determined in good faith by the General Partner. Fair value is based on the best information available and is determined by reference to information including, but not limited to, the following: operating results, financial condition, public or private transactions, valuations for publicly-traded compatible companies, recent purchases of the same or similar securities, progress of clinical trials or other operational progress of an investment's product, and/or other measures, and consideration of any other pertinent information including the types of securities held and restrictions on disposition. Public represents a portfolio company whose securities are traded on a public exchange such as NASDAQ. The unrealized value of publicly traded securities held shown in parenthesis is valued at the closing market price. The unrealized value of warrants for any publicly traded companies is valued based on the Black-Sholes Method.

M **Total Value**: Represents realized value plus Unrealized Value.

N **Multiple**: Represents the ratio of Total Value, Realized Value or Unrealized Value to the corresponding amount of capital invested, expressed as a multiple.

BRAZIL
The Fund is not listed with any stock exchange, organized over the counter market or electronic system of securities trading. Interests in the Fund have not been and will not be registered with any securities exchange commission or other similar authority, including the Brazilian Securities and Exchange Commission (Comissão de valores Mobiliários - or the "CVM"). Interest in the Fund will not be directly or indirectly offered or sold within Brazil through any public offering, as determined by Brazilian law and by the rules issued by the CVM, including Law No. 6,385 (Dec. 7, 1976) and CVM Rule No. 400 (Dec. 29, 2003), as amended from time to time, or any other law or rules that may replace them in the future.

Acts involving a public offering in Brazil, as defined under Brazilian laws and regulations and by the rules issued by the CVM, including Law No. 6,385 (Dec. 7, 1976) and CVM Rule No. 400 (Dec. 29, 2003), as amended from time to time, or any other law or rules that may replace them in the future, must not be performed without such prior registration. Persons in Brazil wishing to acquire interests in the Fund should consult with their own counsel as to the applicability of these registration requirements or any exemption therefrom. Without prejudice to the above, the sale and solicitation of interests in the Fund is limited to qualified investors as defined by CVM Rule No. 409 (Aug. 18, 2004), as amended from time to time or as defined by any other rule that may replace it in the future.

This Memorandum is confidential and intended solely for the use of the addressee and cannot be delivered or disclosed in any manner whatsoever to any person or entity other than the addressee.

COLUMBIA
Neither this Memorandum nor the interests in the Fund have been reviewed or approved by the Financial Superintendency of Colombia (the "FSC") or any other governmental authority in Colombia, nor has the Fund or any related person or entity received authorization or licensing from the FSC or any other governmental authority in the Colombia to market or sell interests in the Fund within Colombia. No public offering of interests in the Fund is being made in Colombia or to Colombian residents. By receiving this Memorandum, the recipient acknowledges that it contacted New Leaf at its own initiative and not as a result of any promotion or publicity by New Leaf. This Memorandum is strictly private and confidential and may not be reproduced, used for any other purpose or provided to any person other than the intended recipient.

DENMARK
This Memorandum has not been and will not be filed with or approved by the Danish Financial Supervisory Authority or any other regulatory authority in Denmark and Limited Partner Interests in the Fund have not been and are not intended to be listed on a Danish regulated market. Limited Partner Interests in the Fund have not been and will not be offered in Denmark under the E.U. Alternative Investment Fund Managers Directive (as implemented into Danish law). Consequently, this Memorandum may not be made available and interests in the Fund may not be marketed or offered for sale directly or indirectly to any natural or legal person in Denmark except as permitted under applicable rules.

FINLAND
As the Fund is a closed end fund, the marketing of interests in the Fund is not interpreted to be subject to the provisions of the Finnish Act on Mutual Funds (sijoitusrahastolaki, 29.1.1999, as amended, the "MFA"). Accordingly prospective investors should acknowledge that this Memorandum is not a fund prospectus as meant in the MFA and the marketing of interests in the Fund is not subject to a marketing permission from the Financial Supervisory Authority (Finanssivalvonta; "FIN-FSA"). Furthermore, even if interests in the Fund were to be construed as "securities" as defined in the Finnish Securities Markets Act (arvopaperimarkkinalaki, 14.12.2012/746, as amended the "SMA"), based on the exemptions set forth in the SMA, the offering of interests in the Fund would be exempted from the prospectus requirements of the SMA (based on the limited number of Finnish offerees and the minimum investment and transfer restrictions specified herein). Accordingly prospective investors must acknowledge that this Memorandum is not a prospectus within the meaning set forth in the SMA. Prospective investors should also note that neither the General Partner or the Management Company is an investment firm (sijoituspalveluyritys) within the meaning of the Finnish Investment Services Act (sijoituspalvelulaki 747/2012) and they are not subject to the supervision of the FFSA. Any prospective investors should acknowledge that they will not be treated as clients of placement agents (if any) engaged by the Management Company in connection with the placement of interests in the Fund and such placement agents may not be under any duty to safeguard the interests of prospective investors. Furthermore, the Fund is not a property fund as meant in the Finnish Act on Property Funds (kiinteistörahastolaki, 1173/1997). The FIN-FSA has not authorized any offering for the subscription of interests in the Fund; accordingly, interests in the Fund may not be offered or sold in Finland or to residents thereof except as permitted by Finnish law.

This Memorandum has been prepared for private information purposes only and it may not be used for, and shall not be deemed, a public offering of interests in the Fund. This Memorandum is strictly for private use by its holder and may not be passed on to third parties or otherwise distributed publicly.

FRANCE

This Memorandum (including any amendment, supplement or replacement thereto) is not being distributed in the context of a public offering in France within the meaning of Article L. 411-1 of the French Monetary and Financial Code (*Code monétaire et financier*). This Memorandum has not been and will not be submitted to the French *Autorité des marchés financiers* ("AMF") for approval in France and accordingly may not and will not be distributed to the public in France.

Pursuant to Article 211-3 of the AMF General Regulation, French residents are hereby informed that:

1. the transaction does not require a prospectus to be submitted for approval to the AMF;

2. persons or entities referred to in Point 2°, Section II of Article L.411-2 of the Monetary and Financial Code may take part in the transaction solely for their own account, as provided in Articles D. 411-1, D. 734-1, D. 744-1, D. 754-1 and D. 764-1 of the Monetary and Financial Code; and

3. the financial instruments thus acquired cannot be distributed directly or indirectly to the public otherwise than in accordance with Articles L. 411-1, L. 411-2, L. 412-1 and L. 621-8 to L. 621-8-3 of the Monetary and Financial Code.

This Memorandum is not to be further distributed or reproduced (in whole or in part) in France by the recipients of this Memorandum. This Memorandum has been distributed on the understanding that such recipients will only participate in the issue or sale of Limited Partner Interests in the Fund for their own account and undertake not to transfer, directly or indirectly, Limited Partner Interests in the Fund to the public in France, other than in compliance with all applicable laws and regulations and in particular with Articles L. 411-1 and L. 411-2 of the French Monetary and Financial Code.

GERMANY

The Fund has been notified to the Bundesanstalt für Finanzdienstleistungsaufsicht (the German Federal Financial Supervisory Authority or "BaFin") for marketing to (vertrieben as this term is construed under the German Capital Investment Code (Kapitalanlagegesetzbuch - KAGB) in the Federal Republic of Germany solely to professional investors (as this term is construed under the KAGB). The Limited Partner Interests in the Fund may not be distributed in the Federal Republic of Germany or used in connection with any offer for subscription of the Limited Partner Interests in the Fund other than to professional investors. Neither this Memorandum nor any other document relating to the Fund or the Limited Partner Interests in the Fund, as well as the information contained therein may be supplied in Germany to persons other than professional investors.

HONG KONG

The contents of this Memorandum have not been reviewed or approved by any regulatory authority in Hong Kong. This Memorandum does not constitute an offer or invitation to the public in Hong Kong to acquire interests in the Fund. Accordingly, unless permitted by the securities laws of Hong Kong, no person may issue or have in its possession for the purposes of issue, this Memorandum or any advertisement, invitation or document relating to interests in the Fund, whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong other than in relation to interests in the Fund which are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" (as such term is defined in the Securities and Futures Ordinance of Hong Kong (Cap. 571) (the "SFO") and the subsidiary legislation made thereunder) or in circumstances which do not result in this Memorandum being a "prospectus" as defined in the Companies Ordinances of Hong Kong (Cap. 32) (the "CO") or which do not constitute an offer or an invitation to the public for the purposes of the SFO or the CO. The offer of interests in the Fund is personal to the person to whom this Memorandum has been delivered by or on behalf of the Fund, and a subscription for interests in the Fund will only be accepted from such person. No person to whom a copy of this Memorandum is issued may issue, circulate or distribute this Memorandum in Hong Kong or make or give a copy of this Memorandum to any other person. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this Memorandum, you should obtain independent professional advice.

ICELAND

This Memorandum has been issued to the recipient, for personal use only, exclusively in connection with a private placement of interests in the Fund. Accordingly, this Memorandum may not be used by the recipient for any other purpose nor forwarded to any other person or entity in Iceland. The offering of interests in the Fund described in this Memorandum is a private placement under Icelandic law and the interests in the Fund may only be offered and sold (as well as resold) in Iceland to a person or entity that is a Qualified Investor as defined in Item No. 9 of Article 43 of the Icelandic Act on Securities Transactions. Also, any subsequent transfer or resale of interests in the Fund in Iceland will need to comply with the applicable provisions of the Icelandic Act on Securities Transactions. Prospective Icelandic investors should consult with their own tax advisors as to the tax consequences of an investment in the Fund.

ITALY

The Fund is not a UCITS fund. The offering of interests in the Fund in Italy has not been nor will it be authorized by the Bank of Italy and the Commissione Nazionale per la Società e la Borsa. Interests in the Fund are offered upon the express request of the investor, who has directly contacted the Fund or its sponsor on the investor's own initiative. No active marketing of the Fund has been made nor will it be made in Italy, and this Memorandum has been sent to the investor at the investor's unsolicited request. The investor acknowledges and confirms the above and hereby agrees not to sell or otherwise transfer any Interests in the Fund or to circulate this Memorandum in Italy unless expressly permitted by, and in compliance with, applicable law.

JAPAN

Interests in the Fund are a security set forth in Article 2, Paragraph 2, Item 6 of the Financial Instruments and Exchange Law of Japan (the "FIEL"). No public offering of interests in the Fund is being made to investors resident in Japan and in accordance with Article 2, paragraph 3, Item 3, of the FIEL, no securities registration statement pursuant to Article 4, paragraph 1, of the FIEL has been made or will be made in respect to the offering of interests in the Fund in Japan. The offering of interests in the Fund in and investment management for the Fund in Japan is made as "Special Exempted Business for Qualified Institutional Investors, Etc." under Article 63, Paragraph 1, of the FIEL. Thus, interests in the Fund are being offered only to a limited number of investors in Japan. Neither the Fund nor any of its affiliates is or will be registered as a "financial instruments firm" pursuant to the FIEL. Neither the Financial Services Agency of Japan nor the Kanto Local Finance Bureau has passed upon the accuracy or adequacy of this Memorandum or otherwise approved or authorized the offering of interests in the Fund to investors resident in Japan.

LUXEMBOURG

No public offering of interests in the Fund is being made to investors resident in Luxembourg. Interests in the Fund are being offered only to a limited number of sophisticated and professional investors in Luxembourg. The Commission de Surveillance du Secteur Financier of Luxembourg has not passed upon the accuracy or adequacy of this Memorandum or otherwise approved or authorized the offering of interests in the Fund to investors resident in Luxembourg.

NETHERLANDS

In the Netherlands, Limited Partner Interests in the Fund may only be offered, sold, transferred or assigned, as part of their initial distribution or at any time thereafter, to natural persons who or legal entities which are Qualified Investors as defined in Section 1:1 of the Financial Supervision Act (Wet op het financieel toezicht (the "FSA")). Limited Partner Interests in the Fund may not otherwise be offered, directly or directly, in the Netherlands. Where an offer is made exclusively to Qualified Investors within the meaning of section 1:1 of the FSA, the General Partner is not under an obligation to have the offering memorandum approved by the Dutch Authority for the Financial Markets or by a competent authority of another member state of the European Economic Area in accordance with Prospectus Directive 2003/71/EC and Prospectus Regulation 809/2004/EC.

NORWAY

This Memorandum does not constitute an invitation or a public offer of securities in the Kingdom of Norway. It is intended only for the original recipient and is not for general circulation in the Kingdom of Norway. The offer herein is not subject to the prospectus requirements laid down in the Norwegian Securities Trading Act. This Memorandum has not been nor will it be registered with or authorized by any governmental body in Norway. Interests in the Fund may only be solicited, acquired or offered in or from Norway to investors for a total face value of at least €100,000.

SAUDI ARABIA

Neither this Memorandum nor the interests in the Fund have been approved, disapproved or passed on in any way by the Capital Market Authority or any other governmental authority in the Kingdom of Saudi Arabia, nor has the Fund received authorization or licensing from the Capital Market Authority or any other governmental authority in the Kingdom of Saudi Arabia to market or sell interests in the Fund within the Kingdom of Saudi Arabia. This Memorandum does not constitute and may not be used for the purpose of an offer or invitation. No services relating to interests in the Fund, including the receipt of applications and the allotment or redemption of such interests, may be rendered by the Fund within the Kingdom of Saudi Arabia.

SOUTH AFRICA

Neither this Memorandum nor the interests in the Fund have been approved, disapproved or passed on in any way by the Financial Services Board or any other governmental authority in South Africa, nor has the Fund received authorization or licensing from the Financial Services Board or any other governmental authority in South Africa to market or sell interests in the Fund within South Africa. This Memorandum is strictly confidential and may not be reproduced, used for any other purpose or provided to any person other than the intended recipient.

SOUTH KOREA

In South Korea, interests in the Fund are being offered only to persons prescribed by Article 301, Paragraph 2 of the Enforcement Decree of the Financial Investment Services and Capital Markets Act ("Qualified Professional Investors"). The Subscriber hereby represents and warrants to the Fund that the Subscriber (i) is a Qualified Professional Investor as prescribed by the Financial Investment Services and Capital Markets Act and (ii) is fully aware of the meaning, effect and ramifications of being an Qualified Professional Investor and fully agrees to be treated in accordance therewith.

SPAIN

Interests in the Fund may not be offered or sold in Spain except in accordance with the requirements of the Spanish Securities Market Act (Ley 24/1988, de 28 de Julio, del Mercado de Valores) as amended and restated, Royal Decree 1310/2005, on securities admission to trade on secondary official markets, public offerings or subscriptions, and prospectus required to such effects, and/or subject and in compliance with the requirements contained in such regulations (Real Decreto 1310/2005, de 4 de noviembre, por el que se desarrolla parcialmente la Ley 24/1988, de 28 de julio, del Mercado de Valores, en materia de admisión a negociación de valores en mercados secundarios oficiales, de ofertas públicas de venta o suscripción y del folleto exigible a tales efectos), and subsequent legislation. This Memorandum is neither verified nor registered with the Comisión Nacional del Mercado de Valores, and therefore a public offer of interests in the Fund will not be carried out in Spain.

SWEDEN

This Memorandum has not been nor will it be registered with or approved by Finansinspektionen (the Swedish Financial Supervisory Authority). Accordingly, this Memorandum may not be made available, nor may the interests in the Fund offered hereunder be marketed and offered for sale in Sweden, other than under circumstances which are deemed not to require a prospectus under the Swedish Financial Instruments Trading Act (1991:980) (Sw. lag (1991:980) om handel med finansiella instrument). Accordingly, the offering of interests in the Fund will only be directed to persons in Sweden who subscribe to interests in the Fund for a total consideration of at least €100,000 per investor.

SWITZERLAND

Under the Collective Investment Schemes Act dated June 23, 2006 and revised on September 28, 2012 (the "CISA"), the offering, sale and distribution to non-qualified investors of units in foreign collective investment schemes in or from Switzerland are subject to authorization by the Swiss Financial Market Supervisory Authority ("FINMA") and, in addition, the distribution to certain qualified investors of interests in such collective investment schemes may be subject to the appointment of a representative and a paying agent in Switzerland. The concept of "foreign collective investment scheme" covers, inter alia, foreign companies and similar schemes (including those created on the basis of a collective investment contract or a contract of another type with similar effect) created for the purpose of collective investment, whether such companies or schemes are closed end or open end. There are reasonable grounds to believe that the Fund would be characterized as a foreign collective investment scheme under Swiss law. As interests in the Fund have not been and cannot be registered with or authorized by FINMA for distribution to non-qualified investors, any offering of interests in the Fund, and any other form of solicitation of investors in relation to the Fund (including by way of circulation of offering materials or information, including this Memorandum), must be restricted to investors considered as qualified investors within the meaning of the CISA and its implementing regulations. Failure to comply with the above-mentioned requirements may constitute a breach of the CISA.

UNTIED ARAB EMIRATES

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UNITED KINGDOM

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7. What is the difference between money laundering and terrorist financing?

In contrast to money laundering, which involves the disguising of funds derived from illegal activity so they may be used without detection of the illegal activity, terrorist financing can involve the use of legally derived money to carry out illegal activities. The objective of money laundering is financial gain or the hiding or disguising of illicit proceeds, whereas with terrorism, the objective is to promote the agenda or cause of the terrorist organization. For example, it is widely believed that the terrorist activities of September 11, 2001, were partially financed by legally obtained funds that had been donated to charities. Both money launderers and terrorists, however, do need to disguise the association between themselves and their funding sources.

8. Is the approach to combat money laundering and terrorist financing the same?

Although some of the risk factors and red flags that apply to other types of money laundering also may apply to terrorist financing, the patterns of activity tend to be very different. Terrorist financing often involves very small amounts of funds, which may be moved through charities or nontraditional banking systems, whereas other types of money laundering may involve large volumes of funds. It is important to understand the different patterns to protect against the risks.

Overview of U.S. AML Laws and Regulations

9. What are the key U.S. AML laws and regulations?

The key U.S. AML laws and regulations are the Bank Secrecy Act of 1970 (BSA) and the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (commonly referred to as the USA PATRIOT Act).

The BSA was the first major money laundering legislation in the United States. It was designed to deter the use of secret foreign bank accounts and provide an audit trail for law enforcement by establishing regulatory reporting and recordkeeping requirements to help identify the source, volume and movement of currency and monetary instruments into or out of the United States or deposited in financial institutions. For additional guidance on the Bank Secrecy Act, please refer to the Bank Secrecy Act section.

The USA PATRIOT Act was signed into law by President George W. Bush on October 26, 2001, following the terrorist activity of September 11. Title III, the International Money Laundering Abatement and Anti-Terrorist Financing Act of 2001, deals with money laundering and terrorist financing. Title III made significant changes to money laundering regulations, imposed enhanced requirements for AML programs, and significantly expanded the scope of coverage to nonbank financial institutions. It requires financial institutions to establish AML programs that include policies, procedures and controls, designation of a compliance officer, training, and independent review. It also requires, among other things, that certain financial institutions establish customer identification procedures for new accounts as well as enhanced due diligence (EDD) for correspondent and private banking accounts maintained by non-U.S. persons. For additional guidance on the USA PATRIOT Act, please refer to the USA PATRIOT Act section.

10. What other AML laws have been enacted in the United States?

In addition to the BSA and Title III of the USA PATRIOT Act, other AML laws include the Money Laundering Control Act of 1986 (MLCA), the Anti-Drug Abuse Act of 1988, the Annunzio-Wylie Anti-Money Laundering Act of 1992, the Money Laundering Suppression Act of 1994 (MLSA), and the Money Laundering and Financial Crimes Strategy Act of 1998.

The MLCA established two AML criminal statutes that, for the first time, made money laundering a criminal offense, with penalties of up to 20 years and fines of up to $500,000 for each count. Additionally, the MLCA prohibits the structuring of currency transactions to avoid filing requirements and requires financial institutions to develop BSA compliance programs.

The primary purpose of the Anti-Drug Abuse Act of 1988 was to provide funding and technical assistance to state and local units of government to combat crime and drug abuse. This Act increased the civil and criminal penalties for money laundering and other BSA violations to include forfeiture of any property or asset involved in an illegal transaction related to money laundering. It introduced the "sting" provision, which enables law enforcement to represent the source of funds involved in a transaction as the proceeds of unlawful activity. This Act also required the identification and recording of purchases of monetary instruments, including bank checks or drafts, foreign drafts, cashier's checks, money orders or traveler's checks in amounts between $3,000 and $10,000 inclusive. This legislation, in conjunction with the Office of National Drug Control Policy (ONDCP) Reauthorization Act of 1998, authorized the Director of the ONDCP to designate areas within the United States that exhibit serious drug trafficking problems and harmfully impact other areas of the country as High Intensity Drug Trafficking Areas (HIDTAs). The HIDTA program aims to improve the effectiveness and efficiency of drug control efforts among local, state and federal law enforcement agencies.

The Annunzio-Wylie Anti-Money Laundering Act of 1992 gave protection from civil liability to any financial institution, or director, officer or employee thereof, who/that makes a Suspicious Activity Report (SAR) under any local, state or federal law. The Annunzio-Wylie Act made it illegal to disclose when a SAR is filed. It also made it illegal to operate a money transmitting business without a license where such a license is required under state law, and required all financial institutions to maintain records of domestic and international funds transfers. In addition, this Act introduced the "death penalty," mandating that bank regulators consider taking action to revoke the charter of any banking organization that is found guilty or pleads guilty to a charge of money laundering.

The Money Laundering Suppression Act of 1994 (MLSA) specifically addressed money services businesses (MSBs), requiring each MSB to register and maintain a list of its agents. In addition to making it a federal crime to operate an unregistered MSB, the MLSA encouraged states to adopt uniform laws applicable to MSBs. It also established procedures that allowed banks to exempt certain customers from Currency Transaction Report (CTR) filing.

Continuing with the trend of developing a national strategy to combat money laundering, the Money Laundering and Financial Crimes Strategy Act of 1998 called for the designation of areas at high-risk for money laundering and related financial crimes by geography, industry, sector or institution. Some of these areas were later designated as High Risk Money Laundering and Related Financial Crimes Areas (HIFCAs). The HIFCA program was created to coordinate the efforts of local, state and federal law enforcement agencies in the fight against money laundering.

The Intelligence Reform and Terrorism Prevention Act of 2004 amended the BSA to require the U.S. Treasury Secretary to prescribe regulations requiring certain financial institutions to report cross-border electronic transmittals of funds, if the Secretary determines such reporting is "reasonably necessary" to aid in the fight against money laundering and terrorist financing.

11. What is the role of the Office of Foreign Assets Control (OFAC) and how does it fit into AML laws and regulations?

The purpose of OFAC is to promulgate, administer and enforce economic and trade sanctions against certain individuals, entities and foreign government agencies and countries whose interests are considered to be at odds with U.S. policy. Sanctions programs target, for example, terrorists and terrorist nations, drug traffickers and those engaged in the proliferation of weapons of mass destruction.

Overviews and details of the OFAC Sanctions programs can be found on OFAC's website at www.treas.gov/ofac.

OFAC regulations are not part of AML compliance per se, but since the OFAC Sanctions lists include alleged money launderers and terrorists and USA PATRIOT Act requirements mandate that certain financial institutions vet customer names against the OFAC list, institutions often consider the OFAC program to be a subset of their overall AML program. For additional guidance, please refer to the Office of Foreign Assets Control and International Government Sanctions Programs section.

12. How can one measure the effectiveness of an AML regime?

A number of factors can be considered when assessing the effectiveness of an AML regime, including the number of money laundering/terrorist financing investigations, prosecutions and convictions, number and amount of frozen/seized assets, identification of deficiencies in financial institutions in examinations by regulatory authorities, and quality of coordination among financial institutions, regulatory and law enforcement authorities. For additional guidance on tools and techniques used to assess the effectiveness of AML systems, please refer to the Financial Action Task Force section.

13. How do U.S. regulations compare to international AML regulations?

The United States' role as a leader in the fight against money laundering and terrorist financing dates back 40 years to the passage of the Bank Secrecy Act in 1970. Through the ensuing decades and especially following the terrorist activities of September 11, 2001, the United States has reinforced its commitment through the passage of a number of additional money laundering-related laws, issuance of extensive regulatory guidance and aggressive enforcement.

That said, the United States, as with many other major jurisdictions, is not in full compliance with the FATF Recommendations. In fact, FATF in its most recent assessment of the United States' anti-money regime, identified several areas in need of improvement, including: customer due diligence relating to beneficial owners, authorized signers, legal persons and trusts; ongoing due diligence; and general requirements for designated nonfinancial businesses and professions (DNFBPs) (e.g., casinos, accountants, attorneys, dealers in precious metals and stones, real estate agents).

For additional guidance, please refer to the Financial Action Task Force and Mutual Evaluations sections.

For additional guidance on international perspectives, please refer to the International Perspectives and Initiatives section.

14. What are the consequences of not complying with AML laws and regulations?

The consequences of noncompliance with AML laws and regulations may include regulatory enforcement actions, civil and criminal penalties, seizure and forfeiture of funds, and incarceration for the individuals involved. Depository institutions also may be subject to restrictions on growth and expansion and, in the extreme, may have their charters/licenses revoked, a consequence known as the "death penalty." For additional guidance, please refer to the Enforcement Actions section.

15. What factors are considered by law enforcement when it assesses whether an institution or its personnel are guilty of aiding and abetting money laundering or terrorist financing?

When assessing whether an institution or its personnel are guilty of aiding and abetting money laundering or terrorist financing, the authorities consider, among other factors, the following "standards of knowledge":

- **Reckless Disregard –** Careless disregard for legal or regulatory requirements and sound business practice
- **Willful Blindness –** Deliberate ignorance and failure to follow up in the face of information that suggests probable money laundering or illicit activity
- **Collective Knowledge –** Aggregates/attributes the knowledge of employees to the employing company

It is important to remember that under U.S. law, a company may, in general, be held liable for the actions of its employees, regardless of the number or level of employees involved in the wrongdoing.

Overview of the U.S. Regulatory Framework

Key U.S. Regulatory Authorities and Law Enforcement Agencies

16. Who has the authority to assess penalties for violations of AML laws and regulations?

Authority to assess civil penalties rests with the Secretary of the Treasury and is delegated to the Financial Crimes Enforcement Network (FinCEN) and the primary federal regulators or Self-Regulatory Organizations (SROs) (e.g., Financial Industry Regulatory Authority [FINRA]). Some state regulatory agencies have their own authority to assess civil penalties, as well. Criminal penalties are determined through legal proceedings at state or federal levels. The Department of Justice (DOJ) can bring criminal and civil actions, as well as forfeiture actions.

17. Who are the primary federal banking regulators and what are their responsibilities?

The five federal banking regulators include:

- **The Board of Governors of the Federal Reserve System (FRB)** oversees state-chartered banks and trust companies that belong to the Federal Reserve System, financial holding companies, bank holding companies (BHC) and thrift holding companies.
- **The Federal Deposit Insurance Corporation (FDIC)** regulates federally charted banks (e.g., state-chartered banks that do not belong to the Federal Reserve System) as well as state-chartered thrifts.
- **The Office of the Comptroller of the Currency (OCC)** regulates federally chartered banks (e.g., banks that have the word "National" in or the letters "N.A." after their names as well as federal thrifts).
- **The National Credit Union Administration (NCUA)** regulates federally chartered credit unions.

- **Consumer Financial Protection Bureau (CFPB):** Established by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the CFPB is a federal regulator charged with regulating consumer protection for financial products and services.

Other regulatory bodies were authorized by the Dodd-Frank Act, but their mandates deal more specifically with broad prudential considerations and consumer protection.

18. What is the Federal Financial Institutions Examination Council (FFIEC)?

The Federal Financial Institutions Examination Council (FFIEC) is a formal interagency body empowered to prescribe uniform principles, standards and report forms, and to make recommendations to promote uniformity in the supervision of financial institutions. Council members include the four federal regulators: FRB, FDIC, OCC, NCUA, and the State Liaison Committee (SLC). The SLC includes representatives from the Conference of State Bank Supervisors (CSBS), the American Council of State Savings Supervisors (ACSSS), and the National Association of State Credit Union Supervisors (NASCUS).

19. Who are the key nonbanking regulatory agencies?

Nonbanking regulatory agencies include but are not limited to:

- **Securities and Exchange Commission (SEC):** The SEC is the federal regulator of the securities markets and administers the federal securities laws (including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, the Investment Advisers Act of 1940 and the Trust Indenture Act of 1939), with direct regulatory and oversight responsibilities of securities exchanges, securities brokers and dealers, investment advisers and investment companies, and self-regulatory organizations (SROs).
- **Commodity Futures Trading Commission (CFTC):** The CFTC is the federal regulator of U.S. commodity futures and options markets in the United States. It administers and enforces the federal futures and options laws as set forth in the Commodity Exchange Act (CEA) and the accompanying regulations.
- **Financial Industry Regulatory Authority (FINRA):** Formerly known as the National Association of Securities Dealers (NASD), FINRA is an SRO for broker-dealers.
- **Consumer Financial Protection Bureau (CFPB):** Established by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank), the CFPB is a federal regulator charged with regulating consumer protection for financial products and services.
- **National Futures Association (NFA):** The NFA is the SRO for the futures market.
- **New York Stock Exchange (NYSE):** The NYSE is the SRO for exchange member organizations (i.e., registered broker-dealer organized as a corporation, a partnership or an LLC that holds an NYSE trading license or opts for NYSE regulation).
- **National Indian Gaming Commission (NIGC):** The NIGC is an independent federal regulatory agency whose primary mission is to regulate gaming activities on Indian lands.
- **IRS Tax Exempt and Government Entities Division (IRS-TEGE):** The IRS-TEGE provides federal oversight to all nonprofit organizations in the United States, including reviews to determine if nonprofit organizations are facilitating terrorist financing.
- **IRS Small Business and Self-Employment Division (IRS-SBSE):** The IRS-SBSE has been delegated examination authority over all financial institutions that do not have a federal functional regulator as defined in the BSA, including MSBs, insurance companies, credit card companies, nonfederally insured credit unions, casinos (tribal and nontribal), and dealers in precious metals, stones and jewels. The IRS-SBSE also has responsibility for auditing compliance with currency transaction reporting requirements that apply to any trade or business (Form 8300).

For further guidance on the AML responsibilities of broker-dealers, money services businesses and other nonbank entities, please refer to the Nonbank Financial Institutions and Nonfinancial Business section.

20. What are the key law enforcement agencies responsible for combating money laundering and terrorist financing?

Key law enforcement agencies responsible for combating money laundering and terrorist financing include:

- Drug Enforcement Administration (DEA)

- Federal Bureau of Investigation (FBI)
- Department of Homeland Security, Immigration and Customs Enforcement (ICE)
- Department of Homeland Security, Customs and Border Protection (CBP)
- Internal Revenue Service Criminal Investigation (IRS-CI)

21. What are examples of other key agencies with responsibilities to combat money laundering and terrorist financing?

Key agencies with responsibilities to establish policies and strategies to combat money laundering and terrorist financing include, but are not limited to, the following:

U.S. Department of the Treasury

- Office of Terrorism and Financial Intelligence (TFI)
- Office of Terrorist Financing and Financial Crime (TFFC)
- Office of Intelligence and Analysis (OIA-T)
- Financial Crimes Enforcement Network (FinCEN)
- Office of Foreign Assets Control (OFAC)
- Treasury Executive Office for Asset Forfeiture (TEOAF)

U.S. Department of Justice (DOJ)

- Asset Forfeiture and Money Laundering Section, Criminal Division (AFMLS)
- Counterterrorism Section, Criminal Division (CTS)
- National Drug Intelligence Center (NDIC)
- Office of International Affairs, Criminal Division (OIA)

U.S. State Department

- Bureau of Economic and Business Affairs (EB)
- Bureau of International Narcotics and Law Enforcement Affairs (INL)
- State's Office of the Coordinator for Counterterrorism (S/CT)

22. What publications and resources have been provided to the public by U.S. regulatory and/or law enforcement authorities?

Examples of publications and resources include, but are not limited to, the following:

- **FFIEC Bank Secrecy Act/Anti-Money Laundering Examination Handbook –** Provides guidance to examiners for carrying out BSA/AML and OFAC examinations for depository institutions. The manual contains an overview of AML Compliance Program requirements, AML risks (e.g., products, services, transactions and customer types of heightened risk), risk management expectations, industry sound practices and examination procedures. The development of this manual was a collaborative effort of the Federal Reserve, the OCC, the NCUA, the OTS (which has since been dissolved and replaced on the FFIEC by the Consumer Financial Protection Bureau (CFPB), the FDIC and FinCEN to ensure consistency in the application of AML requirements.
- **Bank Secrecy Act/Anti-Money Laundering Examination Manual for Money Services Businesses –** Provides guidance to examiners for carrying out BSA/AML and OFAC examinations for MSBs. The manual contains an overview of AML Compliance Program requirements, risk management expectations, industry sound practices, examination procedures, overviews of the different types of MSBs (i.e., check cashers, currency dealers or exchangers, issuers of traveler's checks and money orders, money transmitters), overview of the relationship between principals and agents, and additional guidance on MSB registration requirements, foreign agent or foreign counterparty due diligence, and recordkeeping and retention requirements for all types of MSBs. The development of this manual was a collaborative effort by the IRS, state agencies responsible for MSB

regulations, the Money Transmitter Regulators Association (MTRA), the Conference of State Bank Supervisors (CSBS), and FinCEN.

- **Bank Secrecy Act Exam Resources –** Developed by the NCUA, this publication provides guidance to examiners for carrying out AML and OFAC examinations for credit unions.
- **FFIEC Information Technology Examination Handbook –** Developed through a collaborative effort of the Federal Reserve, the OCC, the NCUA, the CFPB and the FDIC, the IT Examination Handbook covers key technology topics as they relate to financial services in separate booklets, including:
    - Audit
    - Operations
    - Management
    - Business continuity planning
    - Outsourcing technology services
    - Development and acquisition
    - Retail payment systems
    - Wholesale payment systems
    - E-banking supervision of technology service providers
    - Information security

  The IT Examination Handbook provides guidance on topics such as risks and suggested controls on third-party payment processors (e.g., Automated Clearing House [ACH] providers, remote deposit capture [RDC] providers) and electronic payments (e.g., electronic banking, automated teller machine [ATM]).
- **Anti-Money Laundering (AML) Source Tool for Broker-Dealers –** Developed by the SEC to assist broker-dealers with fulfilling their responsibilities to establish an AML Compliance Program, as required by AML laws and regulations.
- **Template for Small Firms –** This template, available on FINRA's website, is designed to assist small firms in fulfilling their responsibilities to establish an AML Compliance Program, as required by the BSA and its implementing regulations and FINRA Rule 3310, by providing text examples, instructions, relevant rules, websites and other resources.
- **Compliance Self-Assessment Guide –** Developed by the NCUA, this guide is intended for use by a credit union's board of directors and management, compliance officers, and others having responsibility for compliance as part of their duties. While the guide covers most federal consumer protection laws and regulations that affect credit unions, it does not address all federal laws or any state laws.
- **AML e-learning courses –** FINRA offers several e-learning courses and interactive scenarios on AML-related topics, ranging from customer identification procedures to recognizing red flags.
- **U.S. Money Laundering Threat Assessment (MLTA) –** Published in 2005, the MLTA was written by the following agencies, bureaus and offices:
    - Office of Terrorist Financing and Financial Crime (TFFC)
    - Financial Crimes Enforcement Network (FinCEN)
    - Office of Intelligence and Analysis (OIA)
    - Office of Foreign Assets Control (OFAC)
    - Executive Office for Asset Forfeiture (TEOAF)
    - Internal Revenue Service (IRS) – Criminal Investigation (CI)
    - IRS – Small Business/Self-Employed Division (SB/SE)
    - Federal Bureau of Investigation (FBI)
    - Drug Enforcement Administration (DEA)
    - Asset Forfeiture Money Laundering Section (AFMLS)

Financial Crimes Enforcement Network

23. What is the Financial Crimes Enforcement Network, and what is its role in AML regulation?

The Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Treasury Department, was established in 1990 by Treasury Order 105-08. Its mission is to safeguard the financial system from abuses of financial crime. It is the Financial Intelligence Unit (FIU) of the United States, formed to support law enforcement and the financial community in the fight against money laundering, terrorist financing and other financial crimes through the collection, analysis and sharing of BSA information. FinCEN seeks to provide adequate financial intelligence to law enforcement without overburdening the financial community or compromising the privacy of individuals.

The many partnerships of FinCEN are not limited to the United States, but expand internationally to law enforcement, financial institutions and regulatory authorities in foreign countries, as well.

While FinCEN relies primarily on federal functional regulators to examine financial institutions and enforce AML compliance, the regulators look to FinCEN for guidance in the implementation of the BSA and USA PATRIOT Act. FinCEN has issued regulations, in concert with federal functional regulators and the Internal Revenue Service (IRS), related to BSA and AML compliance. FinCEN may issue enforcement actions for violations of the BSA and USA PATRIOT Act through its Office of Enforcement jointly or unilaterally. The Office of Enforcement evaluates enforcement matters, including the assessment of civil money penalties.

24. In what types of initiatives does FinCEN engage?

In 1992, as part of the Annunzio-Wylie Anti-Money Laundering Act, FinCEN formed the Bank Secrecy Act Advisory Group (BSAAG), a task force established to coordinate and inform the financial community about BSA-related matters. The BSAAG includes senior representatives from financial institutions, federal law enforcement agencies, regulatory agencies, and others from the public and private sectors. In 2009, the Financial Fraud Enforcement Task Force (FFETF) was established as a multi-agency task force with federal, state and local partners to improve efforts to investigate and prosecute significant financial crimes, recover proceeds for victims, and address financial discrimination in the lending and financial markets.

FinCEN also has created several communication systems to facilitate the sharing of information among both domestic and international entities. The BSA E-Filing System allows financial institutions to file electronic BSA forms, such as CTRs and SARs, quickly and securely. The Gateway program enables law enforcement agencies and financial industry regulators to have expedited access to BSA records filed with FinCEN. The Law Enforcement and Financial Institution Information Sharing (LEFIIS) system allows law enforcement to receive feedback from financial institutions on subjects of money laundering and terrorism investigations, and is used to facilitate information sharing among financial institutions. FinCEN also developed the Egmont Secure Web (ESW), which is a private network that allows connected FIUs to interface with FinCEN and each other to access information related to money laundering trends, analytical tools and technological developments via e-mail.

Additional tools include the Geographic Threat Assessments and Nontraditional Methodologies Sections, a resource center for emerging methods of money laundering and terrorist financing.

FinCEN also collaborates with other FIUs globally to exchange information supporting AML and counterterrorism initiatives worldwide, and assists other countries with developing their FIUs. For additional guidance on FIUs, please refer to the Key International Groups and Initiatives section.

25. What resources has FinCEN provided to the public?

Among the issuances and resources provided by FinCEN are the following:

- **Statutes and Regulations –** Resource that contains links to BSA and USA PATRIOT Act statutes and codified regulations.
- **Federal Register Notices –** Links to final regulations issued after the date of codification as well as Notices of Proposed Rulemaking (NPRs) in the Federal Register.
- **Guidance –** Clarification of issues or responses to questions related to FinCEN regulations (e.g., completion and filing of Suspicious Activity Reports [SARs]; applicability of the definition of a money services business [MSB] to a particular business activity; applicability of the Safe Harbor provision when sharing SARs under certain circumstances).

In June 2011, FinCEN entered into an MOU with the Consumer Financial Protection Bureau (CFPB), which provides the CFPB direct electronic access to BSA information and analytical materials (e.g., analytical tools, BSA information reviews, etc.) as required and appropriate for the exercise of the CFPB's regulatory authority. In return, the CFPB, upon request, will provide reports on the results of its investigations or examinations and statistical information related to any inquiries to assist FinCEN in understanding and analyzing the value of BSA information.

Enforcement Actions

27. What types of enforcement actions are available to regulators for addressing AML Compliance Program deficiencies and violations?

Regulators have a range of enforcement tools available to address AML Compliance Program deficiencies and violations of AML laws and regulations.

While enforcement actions against nonbanks have increased in recent years, the number of enforcement actions issued by bank regulators continues to outnumber those of other agencies, at least in the United States. Examples of enforcement actions available to U.S. bank regulators in order of severity are:

- **Commitment Letter**: A Commitment Letter is an agreement between a bank's board of directors and a bank regulator in which the board, on behalf of a bank, agrees to take certain actions to address issues or concerns surfaced by the regulator. A Commitment Letter is not legally binding, but the failure of a bank to live up to the terms of the Commitment Letter may subject the bank to more formal regulatory action.
- **Memorandum of Understanding**: A Memorandum of Understanding (MOU) is an agreement between a bank's board of directors and one or more regulatory agencies. The content of an MOU may be similar or identical to more formal enforcement actions, but MOUs are nonpublic documents and, similar to Commitment Letters, not legally binding.
- **Formal Agreements**: A Formal Agreement is an agreement between a bank's board of directors and one or more regulatory agencies. While the contents of a Formal Agreement may mirror those of an MOU, violations of a Formal Agreement can provide the legal basis for assessing civil money penalties (CMPs) against directors, officers and other institution-affiliated parties.
- **Consent Order or Order to Cease and Desist (C&D)**: Consent Orders and Orders to Cease and Desist are agreements between a bank's board of directors and one or more regulatory agencies. Violations of a Formal Agreement can provide the legal basis for assessing civil money penalties (CMPs) against directors, officers and other institution-affiliated parties. The regulator's decision to issue a Consent Order or Order to Cease and Desist rather than a formal agreement is based on its assessment of the severity of the bank's problems.
- **Civil Money Penalties (CMPs)**: Civil money penalties are financial penalties that may be imposed by a regulator against a bank or an individual(s) for a violation of law or regulation or noncompliance with a formal enforcement action.
- **"Death Penalty"**: Under the Annunzio-Wiley Act of 1992, bank regulators have the option – in fact, are obligated to consider – whether the license/charter of a depository institution that is found guilty or pleads guilty to money laundering charges should be revoked. The revocation of a license/charter is known as the "Death Penalty."

Unlike the formal enforcement actions issued by bank regulators, which are usually very prescriptive as to the actions that must be taken to address the identified deficiencies, the enforcement actions taken by securities and futures/commodities regulators generally report findings that detail the nature of the deficiency, but do not prescribe specific corrective action (and accompanying fines have been modest compared to those levied against banks).

28. Does FinCEN have enforcement authority?

FinCEN does have enforcement action authority, which it often uses in conjunction with a financial institution's functional regulators.

29. Beyond the actions and penalties that may be imposed by regulators, are U.S. companies subject to any other potential actions?

Yes. Other actions, such as Deferred Prosecution Agreements (DPA), may result from legal actions.

30. What is a Deferred Prosecution Agreement?

A DPA is an agreement entered into between a prosecutor and a defendant in a criminal case whereby in exchange for successful completion of agreed-upon commitments, the criminal charges against the defendant will be dismissed in their entirety by the prosecutor.

31. What enforcement actions have had a significant impact on the AML landscape?

Certain enforcement actions stand out because of the size of the penalties imposed on the institutions and/or the media attention they received. Examples would include:

- Banking Organizations:
    - **ABN Amro**: In December 2005, ABN Amro was assessed an $80 million Civil Money Penalty (CMP) for failure to implement an adequate system of internal controls reasonably designed to assure compliance with U.S. AML laws and regulations. The CMP cited deficiencies within the North American Regional Clearing Center (NARCC), a unit within the New York Branch of ABN Amro that operated as a clearing center for funds transfers in U.S. dollars for members within the ABN Amro network and more than 400 third-party financial institutions. Specific findings included the following:
        - Failure to staff the compliance function and train compliance personnel adequately
        - Failure to file accurate and timely Suspicious Activity Reports (SARs)
        - Lack of formal procedures for collecting and reviewing due diligence and assessing the risks of foreign financial institutions accessing correspondent banking services
        - Lack of adequate monitoring of funds transfers for potentially suspicious activity, particularly funds transfers conducted by financial institutions independent of the ABN Amro network
        - Failure to incorporate information on subjects of previous SAR filings, terminated relationships, and publicly available information on shell companies into its suspicious activity monitoring program
        - Failure to investigate alerts and utilize the capabilities of its automated monitoring software to manage its money laundering and terrorist financing risk effectively
    - **American Express**: In August 2007, American Express International Bank (AEIB) was issued a Cease and Desist (C&D) order and assessed a $20 million CMP and $55 million forfeiture. American Express Travel Related Services Co. (AETRSC) also was assessed a $5 million CMP. Cross-border payment made total effective charges, including forfeiture, $65 million. AEIB provided private banking services to high net worth clients and AETRSC operated as a money services business (MSB). Specific findings included the following:
        - Failure to implement comprehensive customer due diligence (CDD) and enhanced due diligence (EDD) processes
        - Failure to implement effective control measures for bearer shares and other private investment companies (PICs)
        - Failure to adhere to the internal policies for periodic reviews of high-risk accounts
        - Inadequate transaction monitoring system due to data integrity and other problems
        - Inadequate independent testing of the AML Compliance Program
        - Failure to provide adequate oversight of and accountability for the AML Compliance Program by management of AEIB and its parent company, AEB
    - **Wachovia**: In March 2010, the Office of the Comptroller of the Currency (OCC), FinCEN and the U.S. Department of Justice (DOJ) announced that Wachovia Bank, N.A., had agreed to a Deferred Prosecution Agreement with a forfeiture of $110 million with the DOJ, a civil money penalty of $50 million, a C&D with the OCC, and a civil money penalty (CMP) of $110 million with FinCEN. FinCEN agreed its CMP would be satisfied by the payment of the DOJ forfeiture. Specific findings included the following:
        - Failure to implement adequate policies, procedures and controls for bulk cash transactions conducted by high-risk *casas de cambio* and other foreign correspondent banking customers

  - Failure to conduct monitoring of the high volume of monetary instruments through *casas de cambio* and other foreign correspondent customers using Remote Deposit Capture (RDC) service
  - Failure to monitor sequentially numbered traveler's checks used by *casas de cambio* and other foreign correspondent customers in a manner compliant with internal policy on these transactions
  - Failure to institute appropriate risk-based monitoring of foreign correspondent banking customers – primarily as a result of setting alert parameters based on staffing capacity
  - Failure to file timely SARs on several foreign correspondent banking customers
  - Failure to report cash structuring activity

- **HSBC:** In October 2010, the Federal Reserve Board announced that it had issued a Cease and Desist Order between HSBC North America Holdings, Inc. (HNAH), New York, New York, a registered bank holding company (BHC), and the Federal Reserve Board. The order requires HNAH to take corrective action to improve its firm-wide compliance risk management program, including its anti-money laundering compliance risk management. Concurrent with the Federal Reserve Board's announcement of its enforcement action, the Office of the Comptroller of the Currency announced its issuance of a Cease and Desist Order against HSBC Bank USA, N.A., McLean, Virginia (HBUS, a subsidiary of HNAH), for violating the Bank Secrecy Act and its underlying regulations.

  HSBC was directed to use its financial and managerial resources as a source of strength for its bank subsidiaries, and in particular HBUS, to ensure that it complies with the OCC Consent Order regarding HBUS' BSA/AML program. It was also directed to "retain an independent consultant acceptable to the [Chicago Federal] Reserve Bank to complete a review of the effectiveness of the firm-wide BSA/AML Compliance Program adopted by HNAH (the 'BSA/AML Review'), and to prepare a written report of findings and recommendations (the 'BSA/AML Report')." In another section of the Order, HNAH was directed to "submit to the [Chicago Federal] Reserve Bank an acceptable written program designed to reasonably ensure the identification and timely, accurate, and complete reporting by HNAH and its subsidiaries of all known or suspected violations of law or suspicious transactions to law enforcement and supervisory authorities, as required by applicable suspicious activity reporting laws and regulations."

  The OCC Order states that the agency found deficiencies in HBUS' BSA/AML Compliance Program – in particular, deficiencies in internal controls for customer due diligence, procedures for monitoring suspicious activity and independent testing. The Order also cited aggravating factors "such as highly suspicious activity creating a significant potential for unreported money laundering or terrorist financing." Specific cited deficiencies included special handling of wire transfers of customers domiciled in countries risk-rated as "standard" or "medium," resulting in limited and ineffective BSA/AML monitoring of two-thirds of the bank's wire activity; failure from 2006 to 2009 to monitor bulk cash transactions with foreign affiliates; failure to perform customer due diligence or enhanced due diligence for its foreign affiliates, inhibiting its assessment of customer risk and the identification of suspicious activity in accounts of those affiliates; failure to address a backlog of suspicious activity alerts (due to inadequate staffing), which caused the bank to file many late SARs; and failure to appropriately designate customers as "high-risk" for BSA/AML monitoring, even when a customer's association with PEPs could harm the bank's reputation. In July 2012, HSBC was the subject of a hearing held by the Senate Permanent Subcommittee on Investigations entitled "U.S. Vulnerabilities to Money Laundering and Terrorist Financing: HSBC Case History."

- **Citibank:** In April 2012, the OCC issued a Cease and Desist Order against Citibank, N.A. for violations of the Bank Secrecy Act (BSA) and underlying regulations. According to the OCC, the order requires the bank to take comprehensive corrective actions to improve its BSA compliance program.

  The compliance program allegedly had deficiencies with respect to internal controls, customer due diligence, the independent BSA and the anti-money laundering audit function, monitoring of its remote deposit capture and international cash letter instrument processing in connection with foreign correspondent banking, and suspicious activity reporting related to that monitoring. These findings resulted in violations by the bank of statutory and regulatory requirements to maintain an adequate BSA compliance program, file suspicious activity reports, and conduct appropriate due diligence on foreign correspondent accounts.

As part of the Order, the Bank is required to arrange for an independent look back for suspicious activity covering areas (and presumably time frames) to be designated by the bank's Examiner-in-Charge.

- Broker-Dealers:
  - **E*TRADE**: In January 2009, FINRA assessed a $1 million penalty against E*Trade Securities and E* Trade Clearing LLC for failure to implement AML policies and procedures to reasonably detect and report potentially suspicious securities transactions. Alerts triggered in the automated monitoring system were limited to those with money movements, thereby eliminating detection and review of potentially suspicious matched or washed trades. The firms relied upon analysts to monitor high-volume online trading activity for potentially suspicious activity manually, without providing necessary automated monitoring tools.

    Additionally, in July 2008, both firms reached a $1 million settlement with the SEC for failure to document their Customer Identification Program (CIP) and verify the identities of more than 65,000 clients from October 2003 to June 2005.
- Money Services Businesses (MSBs):
  - **Sigue Corporation**: In January 2008, FinCEN assessed a $12 million CMP on Sigue Corporation for failure to implement an effective AML Compliance Program in all four core elements as defined in the USA PATRIOT Act: internal controls, designation of compliance officer/personnel, training, and independent testing. The U.S. Department of Justice assessed a $15 million forfeiture and entered into a Deferred Prosecution Agreement (DPA). Payment of the forfeiture satisfied the FinCEN penalty. Specific findings included the following:
    - Lack of defined roles and responsibilities of the compliance function
    - Failure to implement a risk-based suspicious activity monitoring program commensurate with dollar volume and geographic reach
    - Lack of effective supervision and control over agents (e.g., agents advising customers to structure transactions to evade AML reporting requirements)
    - Failure to investigate alerts in a timely manner
    - Failure to file complete, accurate or timely Suspicious Activity Reports (SARs)
    - Inadequate and untailored training program and/or training program not completed by all employees/agents
    - Inadequate independent testing (e.g., not risk-based, insufficient testing, narrow scope) that failed to identify system problems within the AML Compliance Program
  - From 2010 to 2011, seven MSBs were subject to enforcement actions primarily for failure to register with FinCEN as an MSB. All were acting as independent money transmitters. A summary of findings included the following:
    - Failure to register as an MSB or complete biennial renewals with FinCEN
    - Failure to implement an AML program as required for money transmitters
    - Failure to report potentially suspicious transactions on SARs
    - Structuring currency transactions to evade BSA reporting requirements
    - Conspiracy to commit food stamp fraud

32. What have been the most common deficiencies in AML Compliance Programs?

Some common themes have been:

- **Program Violations**: Overall failures supported by "pillar" violations, i.e., the failure of an institution to address adequately its obligation to designate a qualified AML compliance officer; develop and implement appropriate policies, procedures and controls; provide adequate training; and perform periodic independent testing of its AML Compliance Program.
- **Systemic and Recurring Violations**: Pervasive control breakdowns

- **Isolated and Technical Violations**: Limited instances of noncompliance that do not threaten overall program effectiveness

Some common problems and issues include, but are not limited to, the following:

- AML compliance officer (as well as other employees) lacks sufficient experience and/or knowledge regarding AML policies, procedures and tools
- Insufficient/inadequate resources dedicated to AML compliance
- Lack of specific and customized training of employees with critical functions (e.g., account opening, transaction processing, risk management)
- Failure to conduct adequate risk assessments (e.g., customer risk assessment, business line risk assessment, OFAC risk assessment)
- Failure to incorporate risk assessments into a transaction-monitoring process, customer acceptance standards, audits, testing or training
- Inadequate Know Your Customer (KYC) procedures (e.g., CIP, CDD and EDD at or after account opening, including inadequate controls over required fields, inadequate methods of obtaining and/or maintaining current information, lack of reporting capabilities over missing information, and lack of verification procedures)
- Poor documentation maintained for investigations that did not lead to SAR filings
- Poor follow-up on SAR actions (e.g., close, monitor)
- Lack of reporting of key SAR information to senior management/board of directors
- Inadequate tuning, validation and documentation of automated monitoring systems
- Overreliance on software to identify transactions for which CTRs and/or SARs must be filed without fully understanding how the software is designed and what information it does/does not capture
- Exclusion of certain products from transaction monitoring (e.g., loans, letters of credit, capital markets activities)
- Lack of timeliness when filing CTRs and SARs (e.g., reports are manually filed via certified mail, and the date postmarked is not noted)
- Lack of or inadequate independent testing of the AML Compliance Program
- Lack of or untimely corrective actions to prior examination or audit findings

To identify potential gaps in a financial institution's AML Compliance Program, regulatory enforcement actions for AML deficiencies against other (similar) financial institutions should be reviewed to identify the specific violations and related action steps. This enables financial institutions to recognize and correct any potential weaknesses of their own before their next regulatory examination.

AML Compliance Program

33. What types of financial institutions are required to comply with AML laws and regulations?

Under the USA PATRIOT Act, the definition of "financial institutions" was expanded to include more than 20 different types of businesses that provide financial services, including, but not limited to, broker-dealers, currency exchangers, insurance companies, trust companies, dealers in precious metals, stones or jewels, and issuers of traveler's checks, money orders or similar instruments.

For additional guidance on the other types of financial institutions now required to comply with AML laws and regulations, please refer to the USA PATRIOT Act and Nonbank Financial Institutions and Nonfinancial Businesses sections.

34. What are the key components of an AML Compliance Program?

Key components of an AML Compliance Program include, but are not limited to, the following:

- **Designated Compliance Officer –** For further guidance, please refer to the Designation of AML Compliance Officer and the AML Compliance Organization section.
- **Risk Assessments –** For further guidance, please refer to the Enterprise-wide Risk Assessment, Business Line Risk Assessment, Customer Risk Assessment and OFAC Risk Assessment sections.
- **Customer Acceptance and Maintenance Program –** For further guidance, please refer to the Know Your Customer, Due Diligence and Enhanced Due Diligence, Section 326 – Verification of Identification, Section 312 – Special Due Diligence for Correspondent Accounts and Private Banking Accounts and High Risk Customers sections.
- **Large Currency Monitoring and Currency Transaction Report Filing Program –** For further guidance, please refer to the Currency Transaction Reports section.
- **Monitoring, Investigating and Suspicious Activity Report Filing Program –** For further guidance, please refer to the Transaction Monitoring, Investigations and Red Flags and Suspicious Activity Reports sections.
- **Sanctions Program –** For further guidance, please refer to the Office of Foreign Assets Control section.
- **Information Sharing –** For further guidance, please refer to Section 314(a) – Cooperation among Financial Institutions, Regulatory Authorities and Law Enforcement Authorities, Section 314(b) Requirements – Cooperation among Financial Institutions and National Security Letters sections.
- **Recordkeeping and Retention Program –** For further guidance, please refer to the Funds Transfer Recordkeeping Requirement and the Travel Rule, Recordkeeping Requirements for the Purchase and Sale of Monetary Instruments, Form 8300 and Report of Foreign Bank and Financial Accounts sections.
- **Independent Testing –** For further guidance, please refer to the Independent Testing section.
- **Training –** For further guidance, please refer to the AML Training section.
- **Management and Board Reporting –** For further guidance, please refer to the Designation of AML Compliance Officer and AML Compliance Organization section.

It is important to note that not all types of financial institutions are required to have each of the key components listed above. For additional guidance on the AML requirements of nonbank financial institutions, please refer to the Nonbank Financial Institutions and Nonfinancial Businesses section.

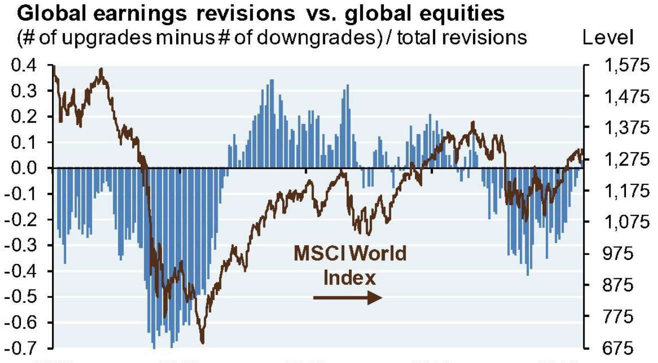
35. How can technology be used to support a financial institution's AML program?

Technology can be used, for example, to support:

- **Monitoring for Suspicious Transactions and Facilitating Suspicious Activity Report Filing –** For further guidance, please see the Suspicious Transaction Monitoring and Suspicious Activity Report Filing Software section.
- **Monitoring for Large Currency Transactions and Facilitating Currency Transaction Report Filing –** For further guidance, please see the Large Currency Transaction Monitoring and Currency Transaction Report Filing Software section.
- **Verification of Customer Information (e.g., CIP) –** For further guidance, please see the Customer Verification Software section.
- **Storage of Customer Information (e.g., CIP, EDD) –** For further guidance, please see the Customer Information Database and Customer Risk Assessment Software section.
- **Calculation of Customer Risk Ratings –** For further guidance, please see the Customer Information Database and Customer Risk Assessment Software section.
- **Searching Against Special Lists of Prohibited and/or High-Risk Individuals/Entities** (e.g., Office of Foreign Assets Control [OFAC], 314(a), Subpoenas, Media Searches, Internal "Deny" Lists, Politically Exposed Persons [PEPs]) for Customers and Transactions – For further guidance, please see the Interdiction Software and List Providers sections.
- **AML Training –** For further guidance, please see the Training Software section.
- **Case Management –** For further guidance, please see the Case Management Software section.

Topics: Is US data as good as it looks? Is Chinese data as bad as it looks? Is European data as bizarre as it looks?

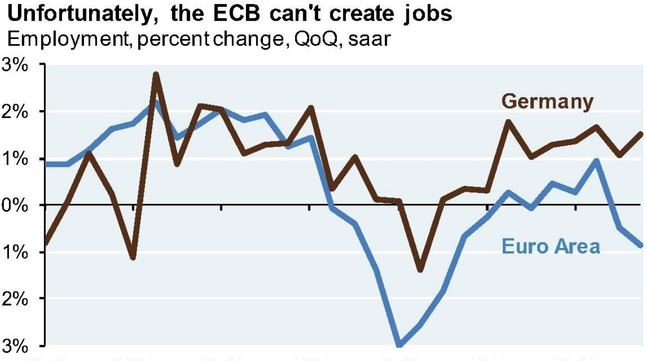
There's also some good news on the global profit outlook, or at least an end to the bad news. A measure of global earnings revisions had been running negative for 40 weeks in a row until last week when it turned slightly positive. Other corroborating evidence comes from conversations we've had with private equity firms, whose portfolio companies are generally planning for 10%-20% increases in capital spending budgets this year.



Global earnings revisions vs. global equities

(# of upgrades minus # of downgrades) / total revisions

Source: Citigroup, Bloomberg.



Unfortunately, the ECB can't create jobs

Employment, percent change, QoQ, saar

Source: Eurostat, Bundesbank.

After four years that challenge some of the basic assumptions of efficient markets and laissez-faire capitalism, there is a pent-up demand for normalcy among individual investors, money managers, CEOs, corporate treasurers, pension funds, regulators, etc. Through massive money creation, Central Banks have provided the veneer of normalcy which has allowed the private sector to get moving again in the US, or at least in the case of Europe, to stop declining. Markets love it. Is the ECB's Mario Draghi a genius? Only time will tell. The last time the term *Maestro* got thrown around, it was a case of premature exaltation.

The latest from Europe: my head is hot and my feet are freezing

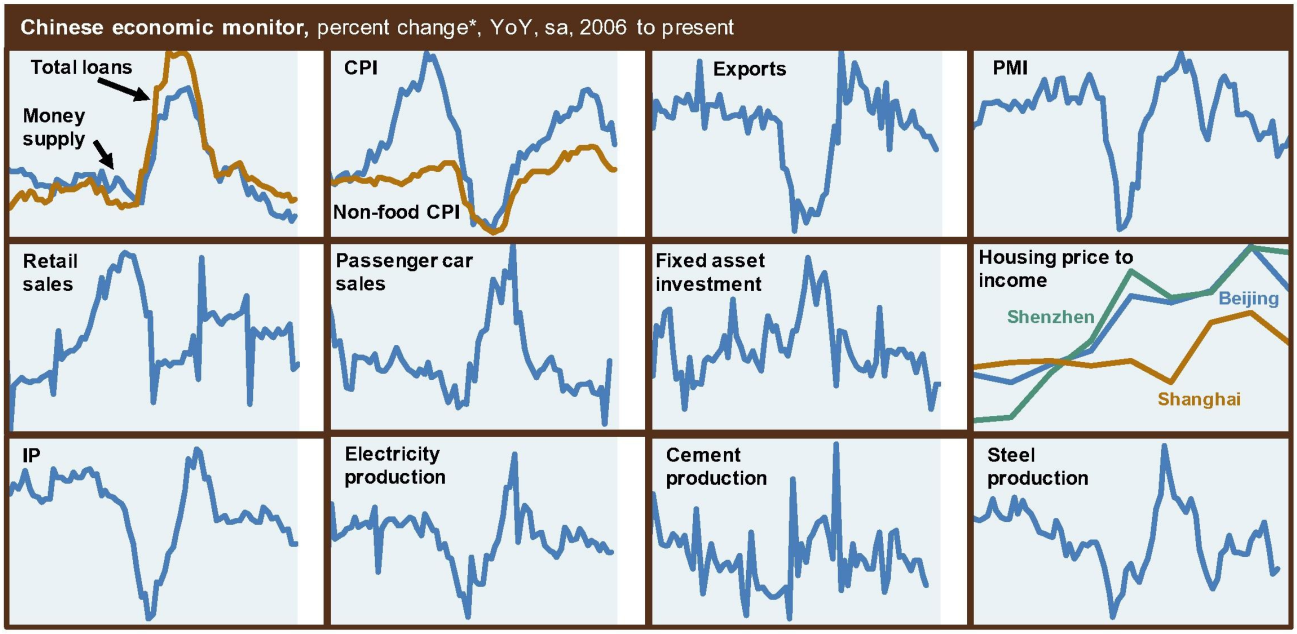
Angela Merkel described Europe as being "a good way up the mountain path" regarding the debt crisis. Courtesy of the ECB, there has been a dramatic improvement in sovereign and bank debt markets. However, in the real economy, improvements are much harder to find. In contrast to improving labor markets in the US, Europe still looks pretty bad outside Germany (see chart above; the declining Euro Area line *includes* the better data from Germany). Other variables related to production and consumption show the same regional divergences. The challenge for Spain looks particularly daunting, given a less open economy than countries like Ireland, escalating costs associated with bank recapitalization and municipal funding shortfalls, and the likely continued withdrawal of foreign capital from the private sector. Even with continued German assistance, it's going to be a long and freezing mountain hike for the periphery.

On investments, we saw a lot of things we recognized in a 76-page Morgan Stanley paper on bank deleveraging and real estate. This has been one of our primary investment themes over the last year. **MS estimates 3 trillion Euros of deleveraging by European banks in the next 3-5 years, even *with* ECB repo facilities slowing the pace of asset dispositions, and a more relaxed approach to Basel 3**. Europe's greater reliance on banks to finance commercial property investments (versus capital markets) is a primary driver here. One example: amazingly, Spanish banks have more domestic commercial real estate loans than UK and German banks combined. There are likely to be opportunities in purchasing loan portfolios, and in providing capital to refinance existing loans. In an environment of low growth, perpetual austerity and rising consumer stress, and the lingering possibility of a devaluation in some countries, buyer portfolio discounts need to be large enough to make sense.

Where is China heading?

There is a roiling epistemological debate as to whether China's current decline is structural or cyclical. As an aside, two of JP Morgan's investment banking analysts (one an economist, the other an equity market strategist) have taken opposite sides of the debate, which is in and of itself a healthy thing. Like the question about whether Italy has a liquidity crisis or a solvency crisis, the answer depends on your definition, and definitions can change depending on how governments respond. On the following page, we include our own China Dashboard we use to track what's going on. Now that we have February data as well as January and can adjust for some of the New Year effects, it's pretty clear that China is slowing. Markets are still nervous, since Premier Wen stated that the government is still concerned about elevated home prices, and that they will continue tight policies on property markets. Home price to income ratios in some major cities exceed peak 2006 California levels.

But with the collapse in Chinese inflation, the government has room to re-stimulate a bit. Recently, the Chinese government has injected more liquidity; expanded the quota for foreign equity investment; cut bank reserve requirements; delayed tighter capital adequacy rules; created a program through which municipalities can issue bonds with government guarantees (rather than having to borrow from banks); eased first time homebuyer restrictions; and injected capital into its biggest banks. **What the China debate is really about is whether these measures will reinvigorate growth or not.** Since much of the recent slowdown was self-imposed due to inflation concerns, it seems reasonable to us to expect the Chinese economy to respond positively to stimulus should it be reapplied. **We are not big buyers of Chinese onshore equities for reasons we have explained before, but we do rely on 7%-8% Chinese GDP growth to fuel economic activity in Asia that underpins many of our investments there. As things stand now, we see no reason why this growth target will not be achieved.**


Chinese economic monitor, percent change*, YoY, sa, 2006 to present

Source: National Bureau of Statistics, PBOC, China Automotive Information, China Economic Information Network, CLSA-Markit, Haver Analytics. J.P. Morgan Securities LLC, ISI Group, J.P. Morgan Private Bank. * PMI data are index level. Housing price to income, cement production and steel production are as of Dec. 2011. All the other data are as of Feb. 2012.

Michael Cembalest
Chief Investment Officer

"*What a diff'rence a day makes*", Dinah Washington, 1959, Mercury Records

"*Banks Deleveraging and Real Estate*", Morgan Stanley Research, Francesca Tondi, March 15, 2012

The ECRI (Economic Cycle Research Institute) claims papal infallibility on its historical recession predictions. ECB = European Central Bank. EMU = European Economic and Monetary Union

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Section 1

Base slides

UBS

Summary

"With the global economy continuing to muddle through, we believe that US corporate bonds offer the best risk return."

- **Economy**
  The successful formation of a Greek government after the June 17 elections has reduced the risk of an imminent Greek exit from the Eurozone. However, the Euro debt crisis persists, and further reform and consolidation efforts in Spain and Italy are needed. In the US, economic data weakened recently, but it remains in line with our forecast of moderate growth of around 2% in 2012. The Fed extended "Operation Twist" until the end of the year and is ready to do more if the economic situation deteriorates materially. Meanwhile, Chinese activity data is showing signs of stabilization and inflation remains low. We expect the Chinese economy to gradually pick up in the second half of 2012.
- **Equities**
  Despite our relatively positive outlook for US and Chinese economic growth, ongoing Eurozone issues keep us neutral on global equities. We think US companies are better positioned than their European peers, and thus keep our longer-standing preference for US equities. US earnings are relatively robust and the recovery of the domestic economy continues to support revenues. Furthermore, we keep a moderate overweight in emerging market (EM) equities as valuations are attractive and we expect growth to accelerate in the second half of the year. In the near term EM currency weakness remains a risk factor.
- **Fixed Income**
  High grade government bond yields remain extremely low due to ultra-expansive monetary policy and ongoing investor concerns over global growth. While we expect yields to only rise very gradually in the near term, we continue to see better investment opportunities in other fixed income segments. US high yield remains our favorite asset class, given attractive valuations and a favorable default outlook. We also keep our overweight recommendations on investment grade and EM bonds.
- **Commodities**
  We avoid broad commodity exposure as we see further price weakness ahead. While the worst of the oil sell-off is likely behind us, we see no reason for higher prices in the near term and expect roll costs to weigh on positions.
- **Foreign Exchange**
  In light of the ongoing Eurozone troubles, we continue to prefer the US dollar over the euro. We also prefer the Canadian dollar, given its relatively good growth dynamics, a possible rate hike, and relatively high short rates.

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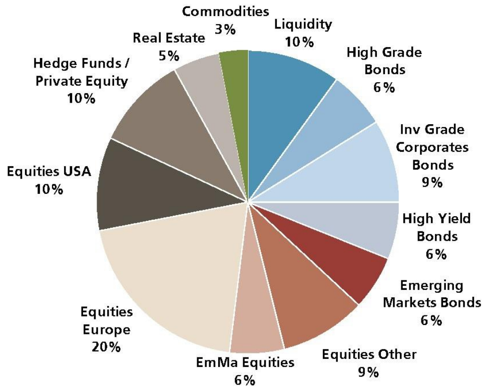
Cross-asset preferences

	Most preferred	Least preferred
Equities	• US • Western winners from EM growth • High quality dividend yields • Event-driven and relative value hedge funds • Natural gas growth gainers	• Europe
Fixed income	• US high yield • Global investment grade credit • Event-driven and relative value hedge funds • EM corporate bonds	• Developed market government bonds
Foreign exchange	• USD • GBP • CAD	• CHF • EUR
Commodities		• Agriculture • Energy

↗ Recent upgrades ↘ Recent downgrades

Portfolio weights



Note: Portfolio weights are for an advisory client with a "EUR moderate" profile. For portfolio weights related to other risk profiles please contact your client advisor.

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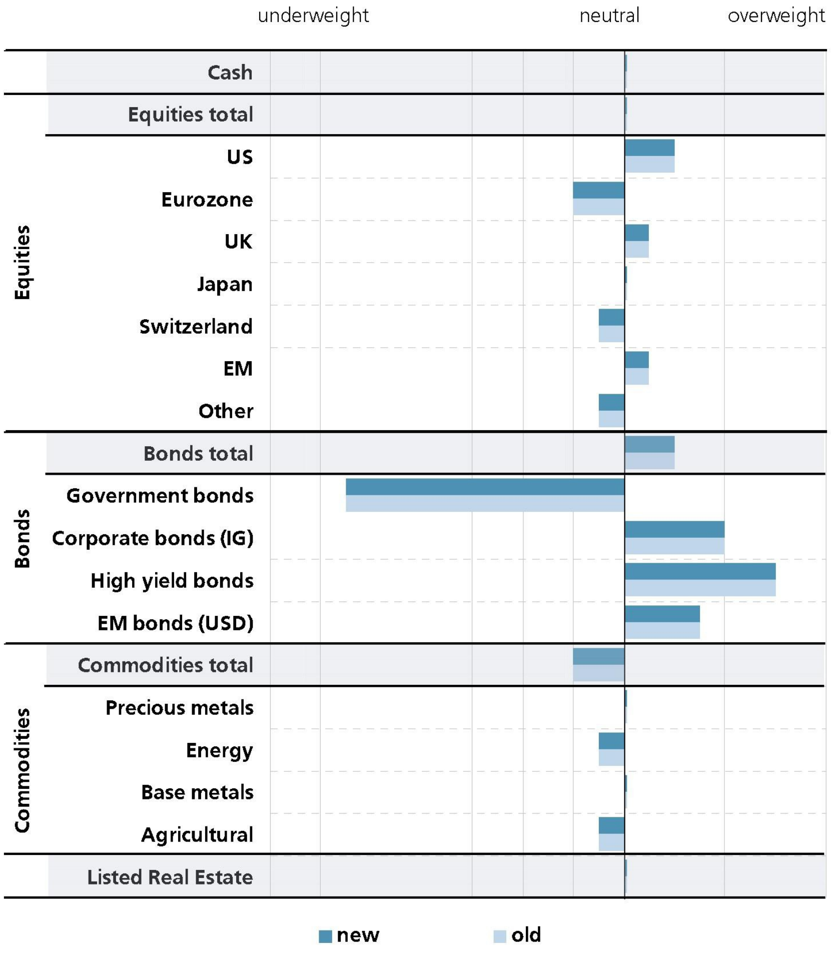
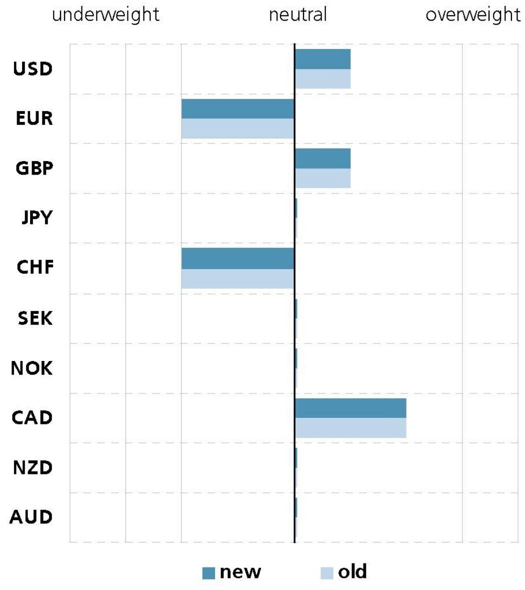
Reference portfolio

Tactical asset allocation deviations from benchmark*



Source: UBS CIO

Currency allocation



* Please note that the bar charts show total portfolio preferences and thus can be interpreted as the recommended deviation from the relevant portfolio benchmark for any given asset class and sub asset class.

Also note that the implementation in advisory or discretionary products might slightly deviate from the "unconstrained" asset allocation shown above, depending on benchmarks, currency positions and for other implementation considerations

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Preferred themes

- **High quality dividend yields (sourced from existing European and UK equities)**
  High quality companies with geographically diversified business models that pay sustainable dividends offer an attractive income stream in a low yield world. Historically, dividends have made a substantial contribution to total returns, and we expect this to remain the case in the current environment.
- **Western winners from emerging market growth (sourced from existing equity holdings)**
  Emerging economies continue to grow faster than developed economies. With little need to deleverage and repair balance sheets, Asian economies are also well positioned to continue to outpace their Western peers in the years ahead. We have identified companies from a variety of sectors in Europe, the US and Japan which have significant exposure to the rapidly growing emerging regions. We believe a diversified portfolio of these companies will reward investors seeking to profit from the robust demand growth in emerging economies.
- **Natural gas growth gainers**
  Natural gas is a relatively clean source of energy, and we think it will benefit from continued substitution for other energy sources over the long term. We have examined the dynamics of the global market and the various components of the gas value chain, and identified the areas we see as the most significant beneficiaries currently. These include producers in Europe and Asia, suppliers of infrastructure, services and related machinery, and Master Limited Partnerships (MLPs) in the US, that offer both attractive yields and growth.
- **Government bond alternatives (sourced from government bonds – CIO UW)**
  Developed world government bonds offer a comparatively small cushion against future interest rate hikes and many face increasing credit risk. We expect select bonds of supranational or national agencies, sub-national governments, multinational corporates, and covered bonds to outperform government bonds. We recommend switching out of government bonds into these alternatives.
- **US high yield corporate bonds (sourced from government bonds – CIO UW)**
  Positive economic growth, robust corporate earnings and healthy balance sheets provide support to US high yield corporate bonds. Current yield spreads of roughly 660 basis points still price in a much more dire economic outcome than we expect. Historically, US high yield bonds have delivered similar returns to US equities with lower volatility. We continue to believe that US high yield corporate bonds represent a more favorable risk/return potential than equities and expect total returns of approximately 7% over the next 6 months.
- **The place to be in Hedge Funds**
  Recent economic data has shown signs of improvement, but growth in most developed markets remains muted. In this environment, less directional hedge fund strategies, such as relative value and event driven, should offer above average returns.
- **EM corporates: a growing asset class (sourced from global government bonds – CIO UW)**
  Given our relatively constructive current view on risk, we regard EM corporate debt as more attractive than EM sovereign debt due to its higher overall yield. Over a 6-month horizon, we expect EM corporate bonds to outperform US Treasuries and deliver total returns of close to 8% p.a.

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Global economic outlook – *Summary*

Key questions

- Can emerging markets (EM) continue to offset developed market (DM) weakness to buoy global growth?
- What are the risks of near-term faltering of the US economic recovery?
- When is the European economy likely to return to sustainable economic expansion?

CIO View (Probability: 60%*)

- Global economic activity remains moderate; the growth impulse stems largely (some 80%) from the EM region. As expected, China started to ease monetary policy. The country is better placed than other EM and particularly DM countries to counter growth weakness with further monetary and fiscal stimuli. Thus, we expect EM growth to stabilize soon and pick up in 2H 2012.
- US economic indicators have on balance been disappointing recently, especially data related to business fixed investment and employment growth. Thus, we lowered our 2Q 2012 real GDP growth forecast to an annualized rate of 1.5% from 2%. We still expect growth slightly above 2% in 2H 2012. We think that the risk that the Fed will take measures in addition to the extension of "Operation Twist" is still significant.
- Large parts of Western Europe are in recession or stagnation. We expect the economies of the Eurozone and the UK to show mild improvement in 2H 2012. Still, economic activity is likely to remain very sluggish despite support from lower oil prices and less rigorous fiscal austerity. The Bank of England may support the UK economy by increasing its amount of bond purchases soon. The probability that the ECB will take further action to support the economy has risen significantly.

↗ **Positive scenario (Probability: 15%*)**

- The Eurozone crisis abates. Financial market conditions recover, mitigating the drag from fiscal austerity.
- Growth in Western Europe is marginally positive (Eurozone stagnates) in 2012 and the US economy grows moderately above trend.

↘ **Negative scenario (Probability: 25%*)**

- There are three key downside risks to the global economy: 1. a significant escalation of the Eurozone debt crisis; 2. a sharp fiscal contraction in the US, and 3. a sharp deceleration of the Chinese economy. Each one of these risks could precipitate a significant downturn of the global economy.

Key dates

2 July	USA: ISM manufacturing PMI for June
5 July	Eurozone: ECB press conference
24 July	Eurozone: purchasing managers indices (PMI), July estimates
22–25 July	China: HSBC flash manufacturing purchasing managers index (Jul)

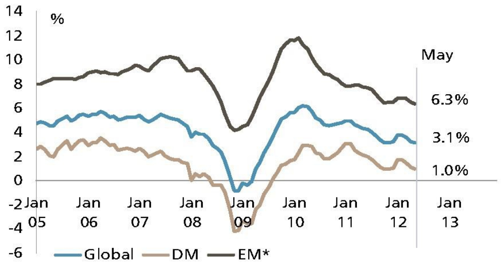
Global growth expected at just under 3% in 2012

		Real GDP growth in %			Inflation in %		
		2011	2012F	2013F	2011	2012F	2013F
Americas	US	1.7	2.1	2.6	3.1	2.1	1.7
	Canada	2.4	2.1	2.4	2.9	2.1	2.3
	Brazil	2.7	2.0	4.8	6.5	5.2	6.5
Asia/Pacific	Japan	-0.7	2.5	2.0	-0.3	0.2	0.5
	Australia	2.1	3.7	3.5	3.4	1.6	2.5
	China	9.2	8.2	8.5	5.4	3.0	4.0
	India	6.5	6.0	7.0	7.8	6.9	7.0
Europe	Eurozone	1.5	-0.4	0.4	2.7	2.3	2.0
	Germany	3.1	1.0	1.1	2.5	1.7	1.5
	France	1.7	0.3	0.4	2.1	2.5	2.2
	Italy	0.5	-1.8	0.2	2.9	3.4	3.9
	Spain	0.7	-1.6	-1.3	3.1	1.9	1.9
	UK	0.7	0.2	1.3	4.5	2.8	1.9
	Switzerland	2.1	1.3	1.7	0.2	-0.4	1.4
	Russia	4.3	3.8	3.7	8.5	4.9	6.9
World		3.2	2.8	3.3	3.9	3.0	3.0

Source: UBS CIO, as of 28 June 2012

In developing the CIO economic forecasts, CIO economists worked in collaboration with economists employed by UBS Investment Research. Forecasts and estimates are current only as of the date of this publication and may change without notice.

Global economic momentum is deteriorating (UBS GDP tracker)



Source: Bloomberg, UBS CIO, as of 22 June 2012

* DM= developed markets, EM = emerging markets

Note: Past performance is not an indication of future returns.

**Scenario probabilities are based on qualitative assessment.

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Key financial market driver 1 – *Eurozone crisis*

Key questions
- What is the way forward for Eurozone banks?
- What is the most likely course of events in Spain, Italy and Portugal?
- In what direction will the economy and the ECB go?

CIO View (Probability: 65%*) **Austerity and weak growth**

- Support for the banking sector is a major political agenda item, and the request for external support for Spanish banks can be seen as the starting point for greater European support and oversight for banks, to be discussed at the upcoming European Council.
- Greece's debt remains unsustainable, but the risk of a euro exit over the next six months has diminished after the 17 June elections, which have produced a viable government coalition. The Troika may only accept moderate adjustments to the second Greek package. Portugal is likely to receive an increased bailout package and is unlikely to default in 2012. Progress on reforms and consolidation in Spain and Italy is most crucial for the near-term development of the crisis. Risk premiums would rise strongly on any failure to meet deficit targets; we expect bond risk premiums to remain elevated for Spain and Italy over the next six months.
- Following stagnation in 1Q 2012, economic surveys are commensurate with a quarterly GDP contraction of around 0.3% at present. Business survey evidence points to a general wait and see mode. The risk to the outlook for a stabilization of economic growth in the second half of 2012 is skewed to the downside. The ECB remains on hold, but the bar to support the economy and markets has been lowered substantially. We see a significant probability of policy action in early July, including the possibility of a rate reduction. Despite all the talk about political measures to support growth and increased tolerance for budget slippages, there is practically no leeway for fiscal stimuli. The near-term growth impact of any fiscal measure will at best be marginal, in our view.

↗ Positive scenario (Probability: 15%*) **Return to macro stability**

- Bond yields are contained, as peripheral countries' budgets stay on track and economic activity recovers faster than expected. Greece fully complies with the austerity plans and receives further support. Market confidence is restored, and economic growth stagnates in 2012.

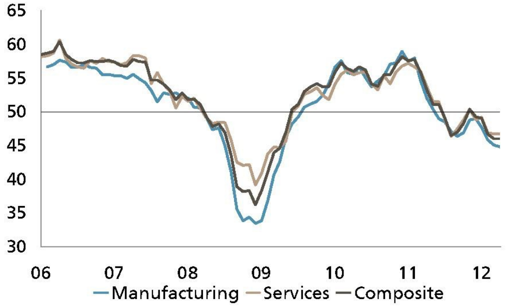
↘ Negative scenario (Probability: 20%*) **Major shock**

- Major shocks could include Spain being pushed into a full IMF/EU program, possibly by a rating cut to junk, enhancing pressure also on Italy; serious political disagreement in core countries (for instance after Dutch elections, etc.); a possible Portuguese default; a Greek euro exit; or a major external growth shock.

Key dates

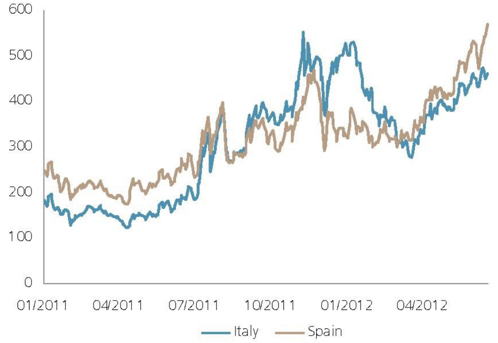
5 July	ECB press conference
9–10 July	Eurogroup/ECOFIN-Meeting
24 July	Eurozone purchasing manager indices (PMI), July estimates

Bottoming in Eurozone leading indicators (PMI) in June?



Source: Bloomberg, UBS CIO, as of 21 June 2012 (estimates)

Yield of Spanish and Italian 10-year bonds over German Bunds (in bps)



Source: UBS CIO, Bloomberg, as of 18 June 2012

Note: Past performance is not an indication of future returns.

* Scenario probabilities are based on qualitative assessment.

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Key financial market driver 2 – *US policy*

Key questions
- Will the economic outlook deteriorate? Will QE3 become necessary?
- How will the election outcome change fiscal policy deliberations?
- Can politicians find an agreement to avoid sharp fiscal contraction in early 2013 ("fiscal cliff")?

CIO View (Probability: 65%*) **No QE3, political gridlock and some fiscal tightening**

- The economy stays on a moderate growth path, coupled with stable core PCE inflation close to the Fed's target of 2%. UBS forecasts real GDP growth of 1.5% in 2Q 2012 (consensus: 2.1%) and 2.3% in 3Q 2012 (consensus: 2.4%), with some downside risk due to rising uncertainty. The Fed has decided to extend so called "Operation Twist" until the end of the year. More near-term monetary easing is still possible, but it is currently not our central scenario.
- In the elections, Republicans will likely lose seats in the House overall, but retain a majority; we also expect them to win a narrow majority in the Senate. Obama will likely retain the White House. Such an electoral outcome would confirm the existing gridlock between Republicans and Democrats.
- Against the backdrop of ongoing political gridlock, we expect only moderate fiscal tightening of about 0.9% of GDP in 2013. The government will likely let unemployment benefits and the payroll tax cut expire, but postpone income tax hikes and sequestration spending.

↗ Positive scenario (Probability: 10%*) **No QE3, Democratic sweep and more fiscal tightening**

- Propelled by ultra-expansive monetary policy and improved confidence, cyclical forces surmount the structural hindrances and thus growth accelerates. More rapid growth leads to higher inflation, and the Fed responds by tightening monetary policy sooner.
- The improved economic outlook raises the odds for an Obama re-election and makes it harder for Republicans to win a majority in the Senate. US fiscal consolidation efforts are facilitated by faster rising tax collections. A Democratic stronghold leads to some tax hikes and limited spending cuts. Fiscal policy tightens by about 1.2% of GDP in 2013.

↘ Negative scenario (Probability: 25%*) **QE3, political dysfunction and huge fiscal tightening**

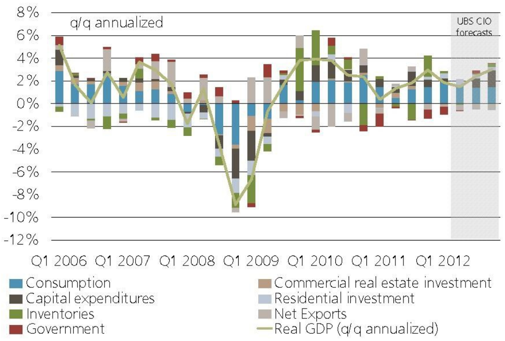
- Structural hindrances dominate and weigh on the cyclical recovery, thus growth weakens or turns negative. The Fed embarks on QE3, most likely in the form of agency MBS and Treasury purchases.
- Weaker economic conditions raise the odds for a larger Republican majority in Congress, but Obama remains President. The debt limit is reached earlier and the Treasury runs out of money before year-end. The political gridlock becomes dysfunctional, thus fiscal policy tightens by USD 600 billion (3.7% of UBS estimate of 2013 GDP) in 2013 ("fiscal cliff"). The US credit rating is downgraded.

Key dates

2 July	ISM manufacturing PMI for June
6 July	Nonfarm payrolls and unemployment rate for June
6 Nov	US Presidential and Congressional elections

US moderate growth to continue

US real GDP and its components, quarter-over-quarter annualized in %



Source: Thomson Datastream, UBS CIO, as of 20 June 2012

US fiscal cliff at year-end 2012

Fiscal effects of change in provisions under current law, USD billion annualized

	1Q13	2Q13	3Q13	4Q13	CY2013
Sequester automatic cuts (discretionary spending)	-60	-68	-76	-76	-70
Sequester automatic cuts (mandatory spending)	-16	-16	-16	-17	-16
2001/2003 tax cuts (250k+ incomes, estate tax)	-38	-58	-58	-65	-55
2001/2003 tax cuts (middle incomes)	-164	-156	-137	-172	-157
Alternative Minimum Tax (incl. interaction with tax cuts)	0	-374	-125	-29	-132
Payroll tax cut	-94	-114	-114	-114	-109
Emergency Unemployment Compensation	-34	-34	-34	-34	-34
Affordable Care Act (3.8%/0.9% tax on passive/wage income 250k+)	-27	-27	-27	-27	-27
Total (all provisions)	-433	-847	-587	-534	-600

Source: Goldman Sachs, UBS CIO, as of 20 June 2012

* Scenario probabilities are based on qualitative assessment.

Note: Past performance is not an indication of future returns.

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Key financial market driver 3 – *China growth outlook*

Key questions
- When will the economy bottom out?
- What economic policy responses can we expect to support the economy ahead?
- How significant is the contagion risk from a possible downturn in the Eurozone?

CIO View (Probability: 70%*) **Modest policy easing to support growth in 2H12**

- The latest economic data suggest that economic activity is showing signs of stabilization, albeit at a comparatively low level. However, we have yet to see meaningful pick-up in activity. We think that policy measures to support the economy should have more visible effect on activity in the second half of the year.
- To this effect, the People's Bank of China (PBoC) has recently cut interest rates by 25bps – the first such move since late 2008. With investment demand still sluggish, we don't expect the measure to have a significant near-term effect on growth. Still, the cut confirms the leadership's commitment to support the economy. Importantly, with the rate cut, measures were announced to increase the banks' ability to set interest rates, which should bolster private household spending power in the future.
- The rate reduction took place against a backdrop of falling price inflation. Thus, inflation is no obstacle for further measures to ease monetary policy. However, at this point we don't expect further rate cuts this year; especially since increased interest rate flexibility should contribute to an easing of monetary conditions ahead. If anything, we think the PBoC may implement more reductions in banks' reserve requirement rates to ensure sufficient liquidity provisions. Thus, we think the real focus has to be on the fiscal policy measures now, including possibly an acceleration of infrastructure investments, measures to support consumer spending and selective relaxation in the property market (while keeping home-purchase restrictions intact).

↗ Positive scenario (Probability: 20%*) **Higher-than-expected growth**

- Chinese GDP grows above 8.5% in 2012. For this we would probably need to see stronger-than-expected fiscal and monetary policy support from the government. A speedy improvement in the Eurozone debt crisis could also lead to this positive scenario.

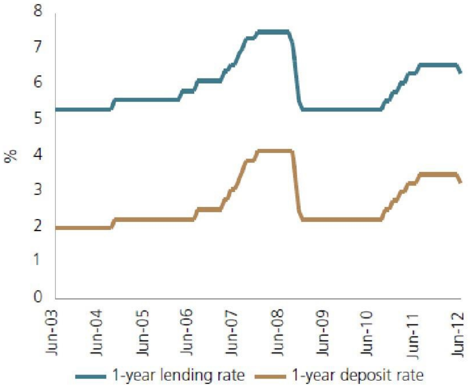
↘ Negative scenario (Probability: 10%*) **Hard landing**

- Chinese GDP growth below 6%, i.e. a hard landing of the economy. This could be triggered by a global financial crisis/recession, causing a slump in Chinese exports. Other risks include a sharp decline in Chinese residential property prices – which would slow investment growth, a large-scale default of local government debt, or a surge in inflation that forces the PBoC to significantly tighten monetary policy.

Key dates

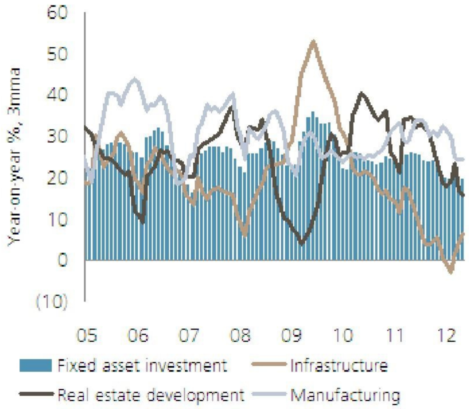
1 Jul	Manufacturing purchasing managers index (Jun)
13 Jul	Fixed asset investment, industrial production (Jun), 2Q12 GDP
11–15 Jul	New bank lending, M2 (Jun)
22–25 Jul	HSBC flash manufacturing purchasing managers index (Jul)

First interest rate cut since 2008



Source: Bloomberg, UBS CIO, as of 18 Jun 2012

Pick-up in infrastructure investment



Source: Bloomberg, UBS CIO, as of 18 Jun 2012

Note: Past performance is not an indication of future returns.

* Scenario probabilities are based on qualitative assessment.

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Section 2

Asset class views

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Section 2.A

Asset class views

Equities

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Equities overview

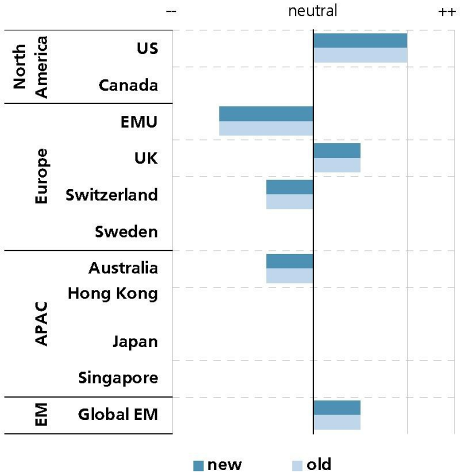
Global equity markets – Key points

- We keep an overall **neutral allocation** to **equities** (see summary on slide 3).
- The **US remains our preferred developed market**. The domestic economy is expected to continue to grow. This should underpin earnings growth for US companies. With labour costs in check, profit margins should stay around the current high levels.
- We **keep our overweight position on EM equities.** Monetary easing in key countries continues, and relatively attractive valuations remain key supporting factors. However, near-term economic and currency weakness remains a major concern for investors – especially those domiciled in hard currency regions (e.g. USD, EUR). Until year-end, we expect some growth acceleration and therefore stay overweight.
- The **UK** remains a **preferred market**. It offers a solid earnings outlook compared to other European markets. Moreover, the valuation is attractive at a trailing P/E ratio close to 10.
- We keep our **negative stance on Eurozone equities**. The economy remains very weak affecting earnings growth negatively. The sovereign debt crisis remains a major risk (see page 8).
- We **remain cautious on Australian equities**. The earnings prospects are still being revised down by analysts. The domestic economy is moving at two speeds with the strong part getting its impulse from the mining sector. We maintain a small underweight.
- We **keep a moderate underweight in Swiss equities**, as valuation looks expensive relative to world equities. The negative earnings impact of the strong Swiss franc should ease further in coming quarters.

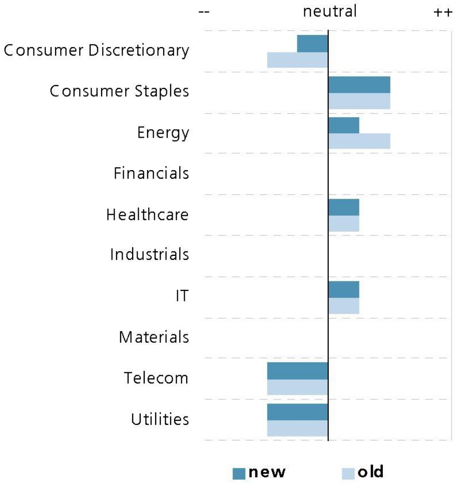
Global equity sectors – Key points

- **Consumer Staples and Healthcare remain preferred** among defensive sectors, as their long-term earnings prospects are very solid. Both sectors also offer strong balance sheets, exposure to favorable demographic trends and emerging markets.
- We keep our **negative view on Telecom and Utilities**. Both sectors suffer from weak revenue growth as well as margin pressure.
- Within cyclical sectors, we **keep our preference for IT** due to a solid earnings outlook and strong corporate balance sheets. Moreover, we **reiterate our neutral allocation to Industrials**.
- Valuations are high and earnings expectations are optimistic for **Consumer Discretionary**. However, we **reduce our Underweight** as we become more positive on the sector in the US.
- Following the latest oil price decline and a good relative performance, we have **reduced our overweight on Energy.** However, the earnings outlook remains solid and valuation is very attractive. While **Materials** are not expensive, we are **neutral**, as margins remain under pressure.
- The earnings outlook for US and Asian Financials is solid, which leads us to be **neutral on Financials from a global perspective.** However, we maintain our underweight on Eurozone Financials, where sovereign indebtedness and bank capitalization remain major concerns.

Preferences (6 months)



Note: Preference in hedged terms (excl. currencies)



Source: UBS CIO, as of 28 June 2012

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Please see important disclaimer and disclosures at the end of the document.

US equities

Preference: overweight

S&P 500 (27 June): 1,332 (last month: 1,319)

UBS View

S&P 500 (6-month target): 1,430

- US firms on average show more resilient earnings than their global and especially European peers. Modest domestic economic growth supports US companies' revenue and thereby earnings growth. About two thirds of revenues are generated in the US.
- While profit margins are slightly higher than their average over the last 30 years, we expect them to hold up in coming quarters. Pressure from rising wages on margins is rather muted. So company earnings are forecast to develop in line with revenues.
- In the next six months, we forecast the price-to-earnings ratio (P/E) of the S&P 500 to rise to about 14.0x realized earnings from slightly above 13.0x currently.
- The combination of expected moderate earnings growth and an expansion of the valuation multiples make the US one of our preferred equity markets.

↗ Positive scenario

S&P 500 (6-month target): 1,580

- An accelerating US and global economy reduces risks to company earnings. Investors begin to shift funds into more cyclical sectors such as Industrials and Materials in light of better growth prospects. In this scenario, we would expect earnings to grow by around 10% in the next 12 months, and the trailing P/E multiple to expand to around 15x.

↘ Negative scenario

S&P 500 (6-month target): 1,115

- The US slides into a recession and corporate earnings fall by around 15% over the coming 12 months. Coupled with an escalation in the Eurozone debt crisis, we would expect the P/E multiple to contract towards 12.0x trailing earnings.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Business sentiment	The ISM is a leading indicator for US manufacturing and services. **Key dates: 2 July, ISM manufacturing; 5 July, ISM non-manufacturing**
The Fed	The direction of monetary policy and hints on further quantitative easing can influence equities. **Key date: 11 July, minutes from June FOMC meeting**
Labor market	Improvement in the labor market is key for domestic consumption. **Key date: 6 July, US labor market report for June**
Earnings reports	Earnings season in the US, with 60% of the S&P 500 companies reporting in July. **Key date: 9 July**, Alcoa, first major earnings report in July

Recommendations

Tactical (6 months)

- We have adopted a neutral allocation between defensive and cyclical sectors.
- Among defensives, we still like Consumer Staples, while IT is a preferred cyclical sectors. We also like Energy.
- We are cautious on Materials, where we expect margin pressure to continue, as well as Telecom and Utilities, due to high valuations.

Strategic (1 to 2 years)

- We like medium-sized US companies, which should benefit from robust earnings growth in the long term (see also slide 21).

Our sector stance in the US

Sectors	US
Consumer Discretionary	→
Consumer Staples	↗
Energy	↗
Financials	→
Healthcare	→
Industrials	→
IT	↗
Materials	↘
Telecom	↘
Utilities	↘

Source: UBS CIO, as of 28 June 2012

Note: Past performance is not an indication of future returns.

UBS

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Eurozone equities

Preference: underweight

Euro Stoxx (27 June): 217 (last month: 215)

UBS View

Euro Stoxx (6-month target): 223

- The crisis in the Eurozone will remain the main driver in the coming months. After the elections in Greece, progress on the reform program will be closely monitored. Spain and Italy will also remain in the spotlight with levels of government bond yields too high for being sustainable.
- With the sovereign debt crisis dragging on we expect the Eurozone market to stay highly volatile in coming months.
- Economies in peripheral countries increasingly feel the burden of austerity. The economic weakness affects company earnings negatively. Analysts' earnings growth forecasts (consensus) for 2012 have come down to about 3% for this year, but we see this as still too high against the weak economic backdrop.
- All in all, the ongoing risks stemming from the sovereign debt crisis lead us to the view that Eurozone equities will underperform other major markets.

↗ Positive scenario **Euro Stoxx (6-month target): 275**

- Global economic growth reaccelerates and Eurozone growth shows clear signs of bottoming out, enabling 2–4% earnings growth over the rest of the year. The trailing P/E ratio could re-rate to 12x from the current reading close to 10x.

↘ Negative scenario **Euro Stoxx (6-month target): 165**

- Europe slides into a deep recession, and the debt crisis leads to severe pressure on Spain and Italy. In a major crisis, earnings could fall by 10% to 15% from current levels until year-end, and the trailing P/E ratio could drop to 8.5x by the end of 2012.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Growth indicators	Economic growth indicators provide information on the development of a potential Eurozone recession. **Key dates: 2 July, Final PMI manufacturing Eurozone, Germany, France for June; 24 July, Flash PMI Eurozone, Germany, France for July; 25 July, IFO business climate Germany**
Policy action	Decisions by European politicians and the ECB affect the course of the debt crisis. **Key dates: 5 July, ECB meeting**
Earnings season	Earnings reports of the Euro Stoxx companies. **Key dates: Mid July until mid August**

Recommendations

Tactical (6 months)

- We continue to recommend defensive sectors. We like Consumer Staples and Healthcare.
- We also like the Energy sector, where the valuation is very attractive.
- Because of risks stemming from the sovereign debt crisis, we keep a cautious stance on Financials – especially Banks and diversified Financials.

Strategic (1 to 2 years)

- For investors with a multiyear horizon, we believe there are attractively valued opportunities in core Europe (see also slide 21).

Our sector stance in the Eurozone

Sectors	Eurozone
Consumer Discretionary	↘
Consumer Staples	↗
Energy	↗
Financials	↘
Healthcare	↗
Industrials	↗
IT	→
Materials	→
Telecom	↘
Utilities	↘

Source: UBS CIO, as of 28 June 2012

Note: Past performance is not an indication of future returns.

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UK equities

Preference: overweight

FTSE 100 (27 June): 5,524 (last month: 5,266)

UBS View

FTSE 100 (6-month target): 5,785

- We continue to like UK equities relative to global ones. An expected improvement in the global economy over the coming quarters should support UK companies as 70% of revenues are generated abroad.
- Energy is the largest sector of the UK market. While the oil price eased sharply over the past months, we expect it to stabilize in the second half of 2012. An attractive valuation of the energy sector at 6.5x trailing earnings provides some buffer for earnings volatility going forward.
- Profitability of UK banks is reasonable. They are less affected by the sovereign debt crisis than their Eurozone peers. While the recent easing of collateral requirements by the Bank of England is supportive in the short-term, the profitability of the domestic operations could be negatively affected by the implementation of the ring-fencing bank reform by 2015.
- UK equities' P/E, at about 10.0x trailing, indicates attractive value relative to global equities. Based on our 12-month forward earnings growth estimate of about 5% and the P/E multiple slightly expanding to 10.3x, we expect UK equities to show good returns over the next six months.

↗ Positive scenario **FTSE 100 (6-month target): 6,650**

- Continued global growth and strong demand from emerging markets should support demand for commodities, helping the Materials and Energy sectors to lead the market higher. The market could re-rate to a P/E multiple of close to 12.0x, and we would expect earnings growth of 5–8% over 12 months.

↘ Negative scenario **FTSE 100 (6-month target): 4,400**

- A global recession drags UK earnings down by 15–20%. The market's defensive characteristics would only partly offset its strong exposure to commodity-related sectors. We would expect the trailing P/E multiple to drop towards slightly below 9x.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Growth indicators	Business survey indicators provide information on the economic development in the UK. **Key date: 2 July, PMI manufacturing for June; 4 July, PMI services for June;**
Commodity prices	Energy and Materials together are about 30% of the UK market by market capitalization. Developments in commodity prices affect earnings estimates.
Policy action	Loose monetary policy by the Bank of England (BoE) supports equities. **Key date: 05 July, Bank of England policy meeting**

Recommendations

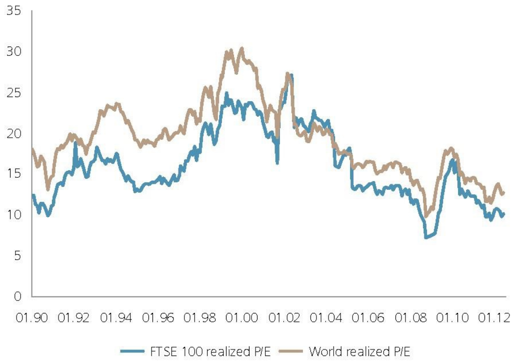
Tactical (6 months)

- We like the Energy sector due to attractive valuations; Consumer Staples is another preferred sector Because of its defensive qualities.
- Approaching the end of the patent cliff should remove some uncertainty on the Healthcare sector and enable a re-rating.

Strategic (1 to 2 years)

- As commodity-related sectors, Energy and Materials should benefit from robust demand in emerging markets.
- The UK market's 4% dividend yield provides a good income stream.

UK market trades at a P/E-discount (based on realized earnings)



Source: Thomson Reuters, UBS CIO, as of 21 June 2012

Note: Past performance is not an indication of future returns.

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Swiss equities

Preference: underweight

SMI (27 June): 5,997 (last month: 5,818)

UBS View

SMI (6-month target): 6,200

- Swiss listed companies generate a high share of profits in economies outside Switzerland. Consequently, the Swiss equity market is affected by the recent weakening in global growth.
- Swiss companies try to mitigate concerns on the global economic prospects by maintaining tight cost controls. This should allow to maintain relatively robust operating margins in 2012.
- While the Swiss franc remains overvalued, we expect the currency impact to gradually become less of a drag. In fact, at current exchange rates, Swiss companies' earnings would show some positive currency translation effects by end 2012, compared to the previous year.
- Still, the PE-ratio of the market is relatively high compared to the global average, indicating less attractive value. The SMI is trading at about 12.8x realized earnings. We are thus more cautious on the ability of the market to deliver further multiple expansion in a challenging market environment. As a result, we maintain a small underweight stance on Swiss equities.

↗ Positive scenario **SMI (6-month target): 6,900**

- Eurozone economic growth reaccelerates meaningfully, providing relief to Swiss financials as well as Swiss exporters. Defensive sectors would likely be left behind in a relief rally. In this scenario, we would expect the equity market P/E to re-rate to 14x and earnings to grow by 5% over the next six months.

↘ Negative scenario **SMI (6-month target): 5,075**

- The sovereign debt crisis re-escalates, leading to further downside for Swiss financials and the export-focused Industrials and Materials sectors. In this scenario, corporate earnings could drop by 5–10% over the next six months and we would expect the P/E to contract significantly, toward 11.5x.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Economic indicators	Key announcement dates of domestic economic indicators: **2 July, PMI manufacturing; 27 July, KOF Swiss leading indicator**
Monetary and economic policy	Key Swiss/European monetary policy dates that can impact Swiss equities: **2 July, SNB meeting; 5 July, ECB Governing Council meeting**
Corporate results	Key corporate announcement dates that could move the market: **5 July, Barry Callebaut; 12 July, Partners Group; 16 July, Kühne+Nagel; 17 July, Georg Fischer & SGS; 19 July, Actelion; 20 July, Sulzer; 25 July, Rieter & Lonza; 26 July, ABB, CS Group, Logitech & Sika**

Recommendations

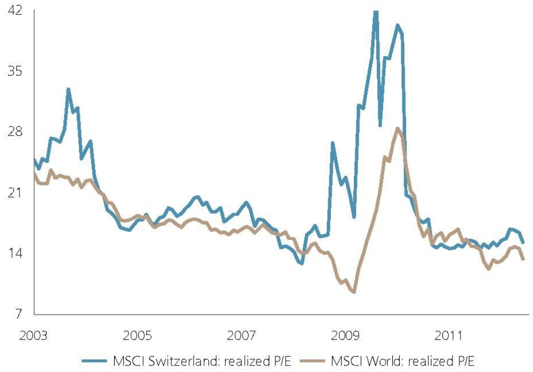
Tactical (6 months)

- We favor companies with a strong and broad foothold in emerging markets, as well as innovative companies able to market their products and services efficiently and globally.
- We continue to favor large caps.

Strategic (1 to 2 years)

- We like stocks paying high and sustainable dividends.
- Moreover, we favor leaders in regards to the two key Swiss success factors: innovation and globalization.

Swiss market trades at a P/E-premium (based on realized earnings)



Source: Thomson Reuters, UBS CIO, as of 25 June 2012

Note: Past performance is not an indication of future returns.

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Japanese equities

Preference: neutral

Topix (27 June): 745 (last month: 721)

UBS View

Topix (6-month target): 780

- We expect earnings growth of about 45% over the coming 12 months. This exceptional high growth is mainly due to the two natural disasters last year, as well as tax regulation changes which caused a number of one-time losses to be booked in the fiscal year that ended in March 2012.
- In our base case scenario, we see only limited scope for an additional earnings boost from the local economic recovery, given the slowing in export markets. Japanese companies are expected to continue their cost reduction efforts to counter the impact of a strong yen.
- The Japanese government has started implementing its JPY 18tn recovery budget in 4Q 2011, and we expect the budget to boost Japanese GDP by 1–1.5% in FY2012.
- Mainly due to the earnings rebound, we expect the TOPIX trailing P/E to drop from around 16.5x to 14x – 14.5x by year end; still the earnings rebound should provide some room for moderate price increases.

↗ Positive scenario

Topix (6-month target): 900

- Stronger global demand and stabilizing European markets provide an additional boost to earnings, and also lead to improved risk taking. Falling risk aversion is likely to lead to a weaker yen, providing further upside to earnings. TOPIX target is based on 16.0x trailing P/E.

↘ Negative scenario

Topix (6-month target): 600

- Faltering global growth leads to weak exports, triggering negative earnings surprises. A strengthening USDJPY below 75 in response to rising risk aversion might provide an additional drag on the economy and earnings. We would then expect the P/E ratio to contract to 13.5x, even if earnings show no recovery.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
JPY and exports	The exchange rate is an important factor for the Japanese equity market, and central bank intervention is a key swing factor. Japan's trade balance could be in deficit and may impact USDJPY rates. **Key date: 09 July, Japanese trade balance**
BoJ's monetary policy board meeting	The Bank of Japan's (BoJ) additional commitment to its asset purchase program, which is currently JPY 65tn in size, would lead to a weaker yen, in our view. **Key date: 12 July, BoJ policy meeting**

Recommendations

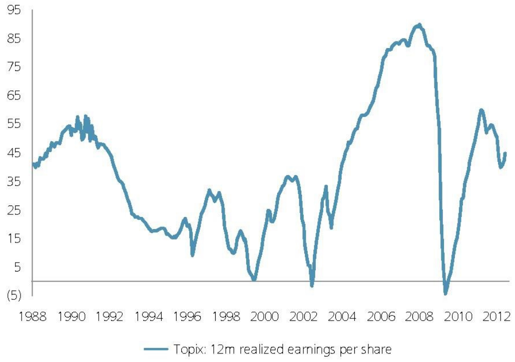
Tactical (6 months)

- The earthquake in Japan and recent floods in Thailand have impacted Japanese earnings negatively. A recovery from these disasters should benefit auto and industrial stocks in particular.
- We prefer companies that continue cost reduction initiatives to maintain price competitiveness during the period of yen strength.

Strategic (1 to 2 years)

- A weaker USDJPY may drive Japanese companies' earnings recovery beyond a technical recovery from natural disasters.
- A rapidly aging population and the lack of a powerful and stable government remain negative for the country's longer-term economic prospects.

Japanese realized earnings likely to recover going forward



Source: Thomson Reuters, UBS CIO, as of 21 June 2012

Note: Past performance is not an indication of future returns.

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Emerging market equities

Preference: overweight

MSCI EM (27 June): 913 (last month: 907)

MSCI EM 6-month target: 1,000

UBS View

- Currency weakness hurt emerging market (EM) equity performance in US-dollar terms year-to-date. We expect EM FX to appreciate against the USD from current levels over a six-month horizon.
- As expected, China has started to ease monetary policy. We believe there is also room to do more on the fiscal side, helping to support China's economic growth outlook for the second half of 2012 and into 2013. The 2Q GDP numbers are expected to represent the low point in the current cycle.
- Given the above, in our base case, we see scope for some multiple expansion for the MSCI EM Index, from the current 10.3x realized price-to-earnings ratio to closer to 11x over the next six months. We expect earnings growth of around 10% over the next 12 months.
- Within EM, we believe that Asia is best positioned for economic growth in the second half of 2012. In emerging Asia, we prefer China. In Latin America, we prefer Brazil and Mexico. Central and Eastern Europe remains the most vulnerable region, and we remain neutral on Russia.

↗ Positive scenario

MSCI EM (6-month target): 1,190

- The outlook for the global economy improves, boosting EM's ability to grow more strongly in 2013. Stronger economic growth leads to earnings growth of 15%. Investor confidence improves, leading to a better P/E multiple of 12.5x trailing earnings. More cyclical Korea and Taiwan would benefit.

↘ Negative scenario

MSCI EM (6-month target): 730

- Serious negative developments (e.g. a further deterioration of the Eurozone crisis, the US fiscal cliff, or a Chinese hard landing) hit trade and thus the economic prospects of emerging markets. In this case, we would expect a 25% decline in earnings. More defensive Malaysia would do better, whereas more cyclical Korea and Taiwan would underperform. We assume, however, that the market would also be expecting some recovery in earnings for 2013, helping the P/E multiple to recover to 9.5x trailing earnings.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Emerging market monetary policy	Investors are trying to figure out which emerging market central banks still have room to ease monetary policy and where rates may be heading up. **Inflation data due for Russia (4–9 July), Brazil (7 July), China (9 July), Mexico (9 July), India (13 July), South Africa (18 July).**
Oil prices & EM FX	Recent declines in oil prices are helping to reverse some of the inflationary impact of earlier rises, but the exchange rate matters, too.

Recommendations

Tactical (6 months)

- In Asia, we expect Chinese equities to benefit as the Chinese economy avoids a hard landing. In Latin America, we prefer Brazil and Mexico.

Strategic (1 to 2 years)

- Structural factors (e.g. stronger fiscal position, more favorable demographics) should continue to support stronger economic growth than in the developed economies.
- Strategically, we would advise a tilt in EM portfolios toward cash-rich and faster-growing Asia.

Emerging market country preferences

Current most preferred markets	Current least preferred markets
Brazil	Hungary
China	Indonesia
Mexico	Poland

We currently have a neutral view on the remaining emerging equity markets in the MSCI EM index.

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Asian equities (ex-Japan)

Preference: overweight

MSCI Asia ex-Japan (27 June): 469 (last month: 466)

UBS View

MSCI Asia ex-Japan (6-month target): 515

- The region continued to show high volatility last month, with its P/BV temporarily close to 2008 lows.
- Hong Kong and Singapore markets' domestic fundamentals remain solid. Hong Kong should benefit from China's gradual recovery in 2H 2012, while Singapore's economy is rebounding and corporate balance sheets and earnings remain solid. After the rate cut early June, we expect China to have more policies to support growth in 2H 2012. China is our most preferred market, while Indonesia is least preferred in the region. We are more concerned about Indonesia's fiscal deficit, since the fuel price hike did not happen. Domestic problems for Indonesia include current account deficits, potential capital outflows, bottomed-out inflation and hiccups in economic and market reforms, in our view.
- We expect 10% earnings-per-share growth over 12 months for the MSCI Asia ex-Japan, which trades on 11.6x 12-month trailing earnings. We expect this multiple to expand slightly in the next six months, as the current earnings downgrade cycle is approaching its end. Nevertheless, MSCI Asia ex-Japan is likely to see further volatility in the near term due to global macro risk factors.

↗ Positive scenario

MSCI Asia ex-Japan (6-month target): 610

- More supportive monetary and fiscal policy, stable inflation, sustained domestic demand growth, and an improved global growth outlook should lead to a better earnings outlook. We would expect earnings growth of 15% and a P/E based on realized earnings of 14x.

↘ Negative scenario

MSCI APAC ex-Japan (6-month target): 380

- A hard landing in China with a global recession leads to negative earnings revisions for 2012. In this scenario, earnings could fall 20% over 12 months and the P/E could fall to about 10.5x.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Growth	Both HK and Singapore's GDP growth disappointed, raising concerns about the growth momentum in the region. Investors should focus on whether growth will re-accelerate in the near term. **Key dates: 3 July, HK retail sales; 13 July, SG retail sales; 17 July, SG exports**
Policy responses	Some other countries in the region have structural issues due to fuel subsidies (e.g. Indonesia) and fiscal deficits (e.g. India). Policy responses often come on an ad hoc base.

Recommendations

Tactical (6 months)

- We prefer Hong Kong banks, Singapore high-dividend stocks and Chinese insurance and consumer plays.
- We are concerned about India's inflation pressure, but we see opportunities in the power and banking sectors.

Strategic (1 to 2 years)

- Rising consumption is the long-term trend in Asia ex-Japan that we expect will continue to play out.
- In China, sectors that contribute to improved labor productivity or deliver goods and services for the elderly should benefit from demographic changes (ageing population and decelerating population growth).

Asia ex-Japan country preferences

Current most preferred markets	Current least preferred markets
China	Indonesia

We currently have a neutral view on the remaining emerging equity markets in the MSCI Asia ex-Japan index.

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Equity styles

UBS View **Prefer value and large caps in Europe, mid caps in US**

- We recommend that investors look for value opportunities in Europe: The cheapest stocks within each sector are at extreme relative valuations, which should begin to normalize. Within Financials, however, investors should limit their direct exposure to the Eurozone debt crisis. We assess the cheapness of a stock by looking at its price-to-earnings and price-to-book ratios relative to its peers.
- We believe US mid caps will outperform large caps. US economic data is forecast to stabilize and GDP growth should be resilient in the second half of 2012. Greater domestic sales exposure reduces earnings risk coming from Europe. In Europe, we prefer large over small caps in the current very challenging economic environment.
- High quality dividend paying stocks provide a real and stable income stream to investors during the current low yield environment. Furthermore, they give exposure to the long term potential of equity markets while also providing some support in declining markets.

➚ Positive scenario **Prefer value, low quality and small caps**

- Leading indicators continue to move higher, and risks related to the Eurozone debt crisis subside. In this case, add deep cyclical value (cheap price/book, price/earnings) regardless of sector, with high beta and high leverage. In such an environment, small- and mid-cap stocks should also perform well, but a dividend strategy would be too defensive to outperform the market.

➘ Negative scenario **Prefer quality and large caps**

- The global economic picture deteriorates markedly. In this case, buy high-quality growth companies and large caps. Do not look for value opportunities, but be as defensive as possible with your equity exposure. Look to high-quality, dividend-paying stocks for yield.

Note: Scenarios refer to global economic scenarios (see slide 7).

What we're watching	Why it matters
Earnings revisions – see chart (3-month moving average upgrades vs. downgrades)	Watch for signs of continued improvement in earnings revisions (aggregated from stock level). An improved earnings outlook would cause investors to add more risk, allowing multiples to expand and triggering the outperformance of value stocks.
US and Eurozone PMIs	If PMIs stabilize or improve, value stocks should outperform as there is no longer justification to pay the high price for earnings stability (quality). **Key dates: 2 July, PMI Manufacturing Eurozone; 2 July, US ISM Manufacturing**

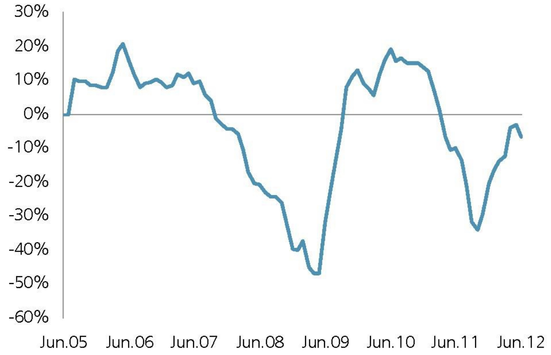
Regional differentiation

- Within Europe, look for value opportunities within each sector, but be aware of the higher-risk Financials.
- In the US, there are opportunities in value names that also show strong growth.
- Within Europe, avoid small caps and instead rotate into large caps.
- In the US, prefer mid caps to large caps while GDP growth is above 2%.

Strategic (1 to 2 years)

- We expect value strategies to outperform the market significantly over the long term.
- Mid-cap stocks provide attractive opportunities over the longer term.

European earnings revisions fell hard last year, but the down cycle might be be ending (net revisions, in %; MSCI Europe)



Source: FactSet, UBS CIO, as of 27 June 2012

Note: Past performance is no indication for future returns.

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Section 2.B

Asset class views

Fixed income

UBS

Bonds overview

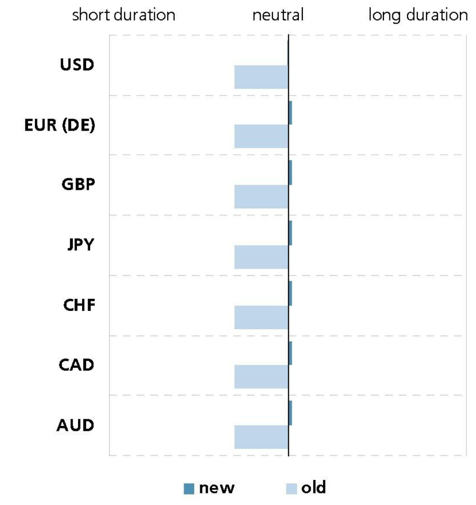
Government bonds – Key points

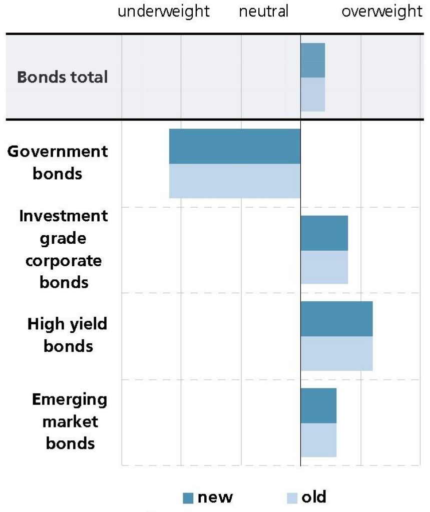
- Government bond yields of major developed markets started to rise from their historical lows ahead of Greek elections, in particular with hopes of more Eurozone integration (e.g. Eurobonds or a European bank deposit guarantee). The new Greek government has at least eased concerns of an imminent and disorderly Greek exit helping yields in their short term rise. However, further central bank easing, including the extension of Operation Twist (OT) until end of 2012 by the Fed limited the further upside potential in yields over the coming months.
- Our expectations for bond yields over the coming 6 months remain a marginal rise. Despite recent setbacks in global growth, the world economy remains in expansion mode. However, OT will keep longer yields low for longer. Also short-term downside risks to bond yields cannot be excluded; Spain has returned to the spotlight, and challenges in Italy's adjustment programs remain. Given current division among European leaders, the mutualization of debt is unlikely to be resolved soon.
- On a relative basis, we prefer German and Swiss bonds, over those in the US and UK, where bond yields could rise faster due to a sounder economic outlook. In particularly in the US, the cyclical recovery looks comparatively more robust.
- Declining growth momentum, extension of Operation Twist by the Fed and a rising likelihood of a rate cut by the ECB, are likely to keep yields on extraordinary low levels, for the time being. Thus we suggest a neutral duration position at this stage.

Corporate and emerging market bonds – Key points

- We maintain our preference for corporate credit (both investment grade and high yield) as well as emerging market bonds, keeping overweight positions in all three segments.
- Investment grade (IG) corporate bonds showed remarkable resilience in the latest downturn. The asset class is likely to outperform government bonds in the coming six months, with higher liquidity and lower volatility than HY bonds. We see the highest return potential in the lower-rated IG segment (BBB and A).
- US corporate bonds of lower credit quality (high yield, HY) remain fundamentally supported by solid balance sheets and a benign US growth outlook. Given the low risk of default losses, valuations are attractive at an effective yield of 7.5%. For US HY, we expect high single-digit total returns in the next six months. US senior loans are an attractive alternative to traditional fixed income assets.
- Emerging market bonds should continue to benefit from better fundamentals than those of developed markets over the medium term. Valuations remain attractive, and the potential for spreads to trend lower should more than offset the gradual increase in US Treasury yields in the quarters ahead. We continue to prefer increasing exposure to corporate bonds while keeping existing investments in sovereign bonds.

Preferences (6 months)





Source: UBS CIO, as of June 19th 2012

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US rates

Duration preference: neutral

US 10-year (29 June): 1.6% (last month: 1.7%)

UBS View

US 10-year (6-month forecast): 1.8%

- US 10-year yields have recovered slightly from their June 1st 2012 lows after a reduction of political risks in the Eurozone. However, Treasury yields remain near historical lows due to the extension of Operation Twist (OT) coupled with recent setbacks of domestic economic data.
- We expect a marginal rise in yields since the US economy remains on a moderate cyclical growth path with the housing market having bottomed out. Additionally the diminished near-term risk of a Greek exit from the Eurozone following elections supports a gradual rise in Treasury yields.
- However, over a six-month horizon, the extension of Operation Twist (OT) until the end of 2012 by the Federal Reserve (Fed) will limit the upside potential in yields. As of late, the probability of even more stimulus in the form of quantitative easing from the Fed has risen substantially and markets have pushed out the first rate hike expectation into 2015. Additionally, structural obstacles from the pending US fiscal consolidation will also limit the upside potential for yields. Further, the US economy seems more vulnerable to possible spillover effects of increased political uncertainties in the Eurozone.

↗ Positive scenario for US bonds **US 10-year (6-month range): 1.5–1.7%**

- The European debt crisis further re-escalates. The resulting contagion would intensify the current flight to quality, with Italian and Spanish spreads above 550 basis points to the Bund (our base case).
- With the increased likelihood of further quantitative easing, the risk is that yields would stay low or fall lower.

↘ Negative scenario for US bonds **US 10-year (6-month range): 2.3–2.9%**

- If the EU leaders indicate serious commitment towards more fiscal integration, and US growth proves more sustainable with a rapidly improving labor market, then yields could rise.
- Recently, market expectations regarding future rate hikes by the Fed have pushed out a first rate hike into 2Q 2015. Any re-pricing into 2014 or 2013 will result in higher yields.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Fed policy	The Fed's assessment of the labour market determines it's stance on quantitative easing and is key for yields. Key dates: **31 July, Federal Open Market Committee meeting**
Labor market	Key focus of the Fed, judged in part based on estimates of the non-accelerating inflation rate of employment. Key date: **6 July, US non-farm payrolls**
Inflation expectations	Current yields reflect low real interest rates, but rather normal inflation expectations. If inflation expectations decline, the risk of a deflationary spiral would exist, leading to more downside risk for long maturity yields.
US presidential election	The US presidential election will guide fiscal spending for the coming years.

Recommendations

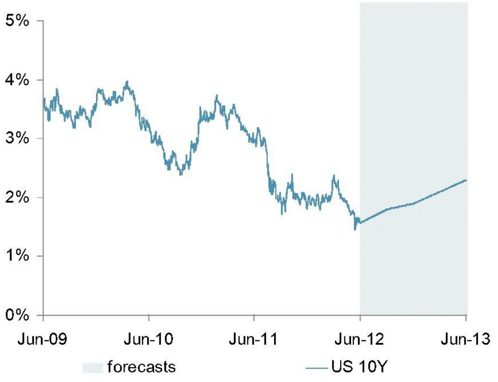
Tactical (6 months)

- Declining growth momentum, extension of Operation Twist by the Fed and a rising likelihood of a rate cut by the ECB, are likely to keep yields on extraordinary low levels, for the time being. Thus we suggest a neutral duration position tactically.

Strategic (1 to 2 years)

- Yields have significant upside potential over the next couple of years given the current extraordinarily low levels – of real interest rates in particular. Thus clients with a longer time horizon should focus on bonds with short and medium maturities

USD 10-year yields and forecasts



Source: Bloomberg, UBS CIO, as of June 18th 2012

Note: Past performance is not an indication of future returns.

UBS

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European rates

Duration preference: neutral

EUR (DE) 10-year (29 June): 1.6% (last month: 1.4%)

UBS View

EUR (DE) 10-year (6-month forecast): 1.7%

- We believe the reasons for the recent rise in Bund yields are numerous: First, signs of more Eurozone integration (e.g. European bank deposit guarantee) combined with the recapitalization of Spanish banks. Second, the firm commitment of central banks to act if downside risks materialize (possible quantitative easing by the BoE and a higher probability of a ECB rate cut) and finally, Greek election results met expectations. However, this rise was muted given the extension of Operation Twist, weak global / German data and Spain's return to the spotlight.
- Over a three- to six-month horizon, we expect growth momentum to remain subdued but still in positive territory; we should have more information on how Spain and Italy are handling their adjustment programs. Also, the new pro-memorandum Greek government should limit safe haven inflows, and thus limit short-term downside risks to yields.
- In the UK, economic data continues to be mixed as the recovery continues but is prone to external shocks. The recent liquidity provision announcement by the BoE has confirmed these concerns.
- In Switzerland, yields have traded range bound owing to conflicting economic data. The SNB stressed increased downside risks to the economy and stands ready to act. However, we believe Swiss yields will gradually normalize.

↗ Positive scenario for German bonds **10-year Bund yield (6-month range) 1.1–1.3%**

- The European debt crisis re-escalates. The resulting contagion would intensify the current flight to quality.
- The economic recovery fails to gain momentum in the second half of the year. Credit demand fails to improve further as some of the recent European Central Bank (ECB) data indicates. The ECB cuts rates.
- Further quantitative easing by the Fed would be supportive for Bunds and speaks for lower yields.

↘ Negative scenario for German bonds **10-year Bund yield (6-month range) 1.9–2.3%**

- A moderate Eurozone economic recovery kicks in, supporting debt-burdened Eurozone countries in their efforts to fulfill austerity commitments and thus reducing the demand for safe-haven assets. Alternatively, Germany gives additional guarantees and the Eurozone moves towards a transfer union.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Elections/EU fiscal consolidation	The EU Summit will show if newly elected governments will change the dynamics in the Eurozone.
Central banks	The revival of the SMP program by the ECB would reduce the yields in the periphery. Their assessments of the current economic situation can give hints of further rate cuts or quantitative easing measures. Key dates: **5 July, ECB rate decision; 31 July, Fed FOMC meeting**
Economic variables	Credit conditions (ECB bank lending survey). Key date: **14 August, Eurozone GDP Q2**
Eurozone yield spreads	The level of yield spreads to German bonds influences the level of German Bund yields due to safe-haven flows.

Recommendations

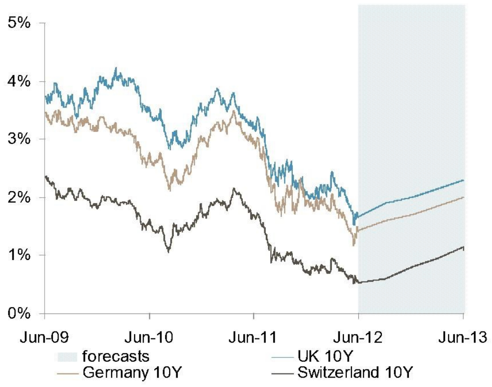
Tactical (6 months)

- Long term Bund yields would fall lower, in case of rising Euro zone break up probability. In contrast if Germany would need to support the periphery further, Bund yields would rise. We expect the market to oscillate between these two cases and recommend to stay neutral on duration tactically.

Strategic (1 to 2 years)

- Yields have significant upside potential over the next couple of years. Thus clients with a long time horizon should focus on bonds with short and medium maturities.

EU 10-year yields and forecasts



Source: Bloomberg, UBS CIO, as of June 18th 2012

Note: Past performance is not an indication of future returns.

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Investment grade corporate bonds

Preference: overweight

Current global spread (26 June): 225bps (last month: 225bps)

UBS View

Spread target (6-month): 170bps

- We expect investment grade (IG) corporate bonds to achieve a total return of around 3% over the next six months. Our spread target of 170bps is based on our benign economic outlook, ongoing investor appetite for income-generating assets and expected negative net issuance. This target spread is still above its 15-year average of 130bps.
- Non-financial corporates: While total yields are at record lows, the pickup over government bonds and money market rates is attractive. Aggressive re-leveraging by companies looks unlikely in the current environment. Credit quality should remain good and non-financials continue to deliver a stable income.
- Financial corporates: Due to regulatory challenges, spreads are expected to remain above past averages. Total returns could outpace non-financials, but volatility will be considerably higher.
- Overall, IG corporate bonds remain a preferred asset class, providing an attractive yield pickup. The asset class offers relatively low volatility and a benign total return outlook. We expect lower-rated issuers (BBB and A) to outperform higher-rated ones.

↗ Positive scenario

Spread target (6-month): 140bps

- Global growth accelerates more forcefully than expected. This could compress spreads to closer to pre-crisis levels. Spreads for Financials are likely to remain elevated due to regulatory challenges. However, in this positive case, rising benchmark yields would limit total returns to 1–2% over six months.

↘ Negative scenario

Spread target (6-month): 400bps

- Even if US economic growth falters, and the European recession turns out to be worse than currently expected, we believe we would be unlikely to see the spread levels reached in 2009, given companies' superior balance sheet positions. European financial issuers would be most at risk in this scenario.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Core market yields	Developed market sovereign yields are only expected to increase gradually. A sudden rise and high volatility would hurt IG credit. **Key dates: 1 August, Federal Open Market Committee meeting**
Corporate fundamentals	Good corporate earnings and low leverage on corporate balance sheets should help prevent defaults.
New issuance	As companies continue to deleverage, net negative supply on the IG market should support higher prices.

Recommendations

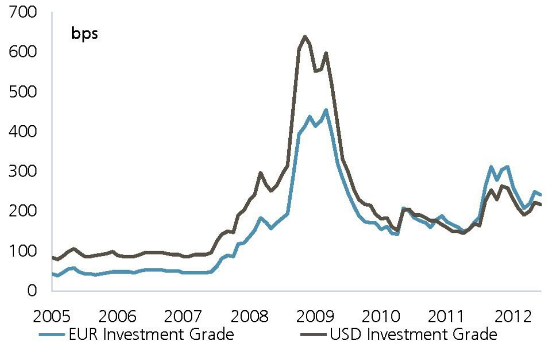
Tactical (6 months)

- We still see room for tighter yield spreads; the return outlook compares very favorably to government bonds.
- Internationally diversified companies from non-financial sectors offer a stable and relatively safe income stream for conservative investors.
- We recommend bonds from the lower IG rating segments (BBB and A) over higher-rated issuers.

Strategic (1 to 2 years)

- We prefer corporate over sovereign assets given companies' robustness compared to the structural weakness of public finance in many countries.

Yield spreads



Source: Bloomberg, UBS CIO, as of 26.June 2012

Note: Past performance is not an indication of future returns.

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High yield corporate bonds

Preference: overweight

Spread USD HY (26 June): 660bps (last month: 660bps)

UBS View

USD HY spread target (6-month): 525bps

• US high yield (HY) bonds continue to offer attractive value; we expect high single-digit total returns over the next six months. We stick to our spread forecast of 525bps based on an ongoing recovery of the US economy, robust company balance sheets, rising earnings, and ongoing investor appetite for higher-yielding assets. US HY bonds remain our preferred asset class.

• Fundamental factors remain supportive. Despite the recent uptick in defaults, in the absence of a renewed US recession only a very gradual increase is to be expected. We forecast a modest rise in the trailing default rate to 3.5% at the end of the year from 3.1% in May. A heavy load of new issuance in the first three months of the year means that HY companies will be faced with a lower risk of failed refinancing going forward (e.g. in case of an unexpected economic slump).

• We acknowledge that ongoing risk aversion could still cause spreads to widen somewhat in the short run. Investors who are able and willing to hold on to their HY position will likely benefit over 6 months.

↗ Positive scenario **USD HY spread target (6-month): 450bps**

• In the positive economic scenario, a rally in high yield bonds and a return to pre-crisis spreads of about 400bps is likely. Benchmark yields would also rise, limiting HY returns to around 10%. European HY outperforms the US.

↘ Negative scenario **USD HY spread target (6-month): 1,200bps**

• A global recession is a major risk for high yield bonds. Based on the more robust state of the corporate sector, we would not expect spreads to widen to 2008/09 peak levels above 2,000bps. Although short-term spikes are likely, due to liquidity suddenly drying up, we would expect a quick return to the "usual" recession-level spread of around 1,200bps.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Credit quality/ default cycle	As long as corporate earnings increase and balance sheets remain backed by high cash levels and low debt ratios, the default rate will remain below its 5% long-term average.
New issuance	For now, favorable conditions in the primary market have mainly been used for refinancing. More aggressive issuance activities should be monitored.
Bank lending standards	Bank lending provides an important source of funding. US banks relaxed standards slightly in 2Q. **Key dates: early-July, ECB bank lending survey; late-July, Fed Senior Loan Officer Survey**

Recommendations

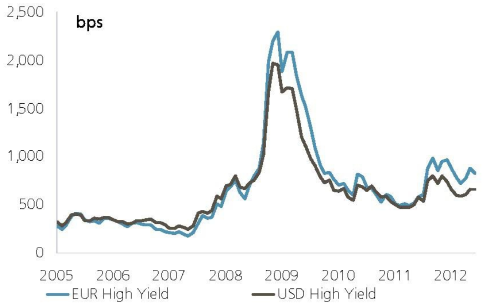
Tactical (6 months)

- US high yield corporate bonds offer an attractive return outlook and should be overweighted.
- We prefer US over European issuers given the poorer economic outlook in Europe and the increasing proportion of peripheral and financial issuers in the European HY universe.
- Inflows into HY mutual funds have been strong so far in 2012, but new issuance has cooled down a bit in April and May.

Strategic (1 to 2 years)

- We expect US defaults to remain at below-average levels for longer. Significant re-leveraging is unlikely in the medium term.
- We believe US high yield corporate bonds will provide good returns for absolute return-oriented investors, as well as relative to other fixed income segments.

Yield spreads



Source: Bloomberg, UBS CIO, as of 26 June 2012

Note: Past performance is not an indication of future returns.

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Emerging market bonds

Preference: overweight

EMBI Global / CEMBI spread (27 June): 388bps / 430bps (last month: 410bps / 440bps)

UBS View

EMBI Global / CEMBI spread target (6-month): 340bps / 350bps

- Emerging market (EM) bond spreads are currently higher than implied by fundamentals, and we think they offer attractive returns even against a more challenging global backdrop.
- The probability remains significant, though, that negative headlines out of the Eurozone or a weakening global growth outlook will put short-term pressure on EM bond prices. However, given EM sovereigns' better average fundamentals, and EM corporates' solid profit growth outlook and low leverage ratios, we think that periods of price weakness should offer attractive entry points.
- Although we revised our spread targets (to 340bps from 300bps for sovereigns, and to 350bps from 310bps for corporates), we continue to expect spreads to trend gradually lower over the next six months, more than offsetting the moderate rise in US Treasury yields we expect in the quarters ahead.

↗ Positive scenario — **EMBI Global / CEMBI spread target (6-month): 290bps / 290bps**

- Yield stability in Europe's core markets and higher-than-expected growth in the US would provide a favorable backdrop for EM fixed income spreads. In such an environment, issuers of lower credit quality would likely fare better. Average spreads could tighten to below 300bps in such an environment.

↘ Negative scenario — **EMBI Global / CEMBI spread target (6-month): 525bps / 700bps**

- An environment of escalating risk aversion in Europe, deteriorating EM funding markets, weakening global growth prospects, and lower commodity prices could impact EM credit negatively. Liquidity in emerging market bonds could dry up and spreads could spike.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Core market yields	The direction of US Treasury and German Bund yields are important for EM fixed income spreads, especially for USD- and EUR-denominated bonds. **Key dates: 1 August, US ISM & FOMC rate decision**
Capital flows	The European debt crisis may lead to further periods of outflows and weaker prices, which could offer attractive entry levels for investors.
Monetary policy cycles	Monetary policy easing remains a key topic for local currency bonds. We look for central bank policy announcements in key markets such as Brazil, Indonesia, Malaysia, Mexico, Poland, South Africa, and Turkey. **Key policy rate announcement dates: 29 June, Colombia; 4 July, Poland; 5 July, Malaysia; 11 July, Brazil; 12 July, Indonesia; 19 July, Turkey**

Recommendations

Tactical (6 months)

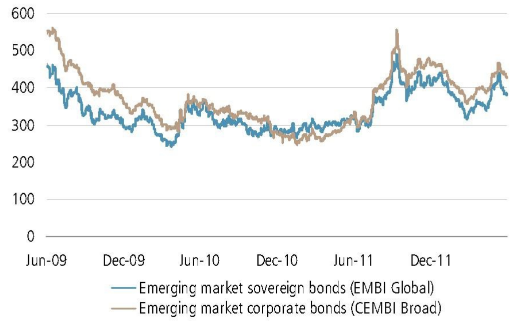
- EM corporate bonds are particularly attractive due to favorable valuation, solid fundamentals, and their relatively short duration. We advise clients to focus on investment grade bonds in the current environment. We continue to like selected sovereign bonds.
- Please refer to our EM bond list for specific guidance.

Strategic (1 to 2 years)

- EM bonds are attractive for longer-term investors looking for higher yields.
- Local markets in Asia offer interesting opportunities for longer-term investors because of a supportive currency outlook.

Room for tightening

Spreads of EM bonds over US Treasuries (in bps)



Source: JP Morgan, UBS CIO, as of 27 June 2012

Note: Past performance is not an indication of future returns.

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Section 2.C

Asset class views

Foreign exchange

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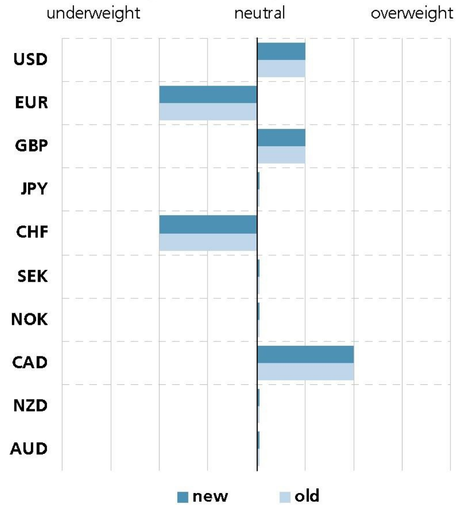
Foreign exchange overview

Foreign exchange – Key points

- **EUR**: Greek election results reduce the near-term euro break-up risk. Now starts a difficult period with re-negotiation of the Greek austerity program. Also Spanish yields, which have reached hard to sustain highs, need to be addressed. As the crisis carries on and hurts growth prospects for Europe well into 2013 we recommend to keep euro short positions. The risk for either an ECB rate cut or an extension of bond purchase program by ECB as well as the increasing risks to the banking system are weighing on the euro.
- The extension of Operation Twist in response to weakening growth outlook in the US has its pros and cons for the **USD**. Global risk aversion and search for alternatives to the euro is supporting the greenback currently. The clear commitment of the Fed to respond with more stimulus to European contagion and the approaching fiscal cliff is limiting the upside potential for the USD.
- The **CAD** has increased in attractiveness recently due to weaker spot rates, while good growth dynamics in Canada still lead to rate hike expectations. We continue to recommend an overweight.
- We keep the overweight position in the **GBP**. The BoE eased monetary conditions for the banking system to protect the UK financial market against contagion effects spilling over from the continent. Apart from this, we think the pound remains well supported, because valuation is cheap and investors are seeking liquid alternatives to the euro.
- **EURCHF** is currently trading at the low end of our expected range of 1.20–1.25, and we therefore keep an underweight position in the CHF. The 1.20 EURCHF floor prevents any CHF appreciation and the SNB has clearly shown in May that it is willing and can protect the floor; we expect the SNB to continue in this.
- Sweden and Norway stand out for their lower debt-to-GDP ratios and current account surpluses. The **NOK** appreciated recently, due to safe haven inflows. We stay neutral as the appreciation potential is now limited. The **SEK** is very sentiment-driven and should profit in the medium term.
- Longer-term debt issues and weak competitiveness of major exporters are hurting the Japanese economy. Therefore the Bank of Japan and Ministry of Finance will maintain an expansive policy and continue to try weaken the **JPY**. However, current positive growth dynamics are supportive of the JPY.
- For commodity currencies, the **AUD** and **NZD** weakened within ranges from March to May. We expect another bout of weakness over the next three months together with increasing European troubles.
- We expect the **CNY** to appreciate 3% against the USD, moving towards 6.15 over the coming 12 months. Internationally marketable instruments (such as CNH, the offshore version of the Chinese currency traded in Hong Kong) have similar appreciation potential. Our most preferred emerging market currencies are currently MXN, ZAR, PLN, ZAR, KRW and CNY.

Preferences (6 months)



Source: UBS CIO, as of 22.06.2012

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G10 currencies

UBS View **see UBS FX forecasts, below-right**

- The negative momentum on the **EUR** is likely to persist. The growth outlook has deteriorated in the last couple of months to a point, which challenges the fiscal austerity efforts seriously.
- The **USD** profits from European troubles, but the upside remains limited by expansive fed policy
- The **GBP** is resuming its uptrend despite stimulus measures by the Bank of England. The main reason is the need for diversification of the EUR and better current economic indicators.
- The **AUD** seems to have found a bottom, and should recover on the back of better risk sentiment. We believe the **CAD** remains one of the most attractive currencies.
- The SNB has shown that it will defend the **CHF**-floor. EURCHF will remain in the 1.20-1.25 range.

➚ Positive scenario **FX targets: EURUSD >1.35 / EURJPY 120**

- Eurozone economies avoid a material contraction and financial market conditions recover. EURUSD should trade above 1.40 in this case. Yen weakness could develop, since hopes for global growth would make the carry-trade role of the yen more prominent.

➘ Negative scenario **FX targets: EURUSD <1.20 / EURJPY 100**

- European growth outlook deteriorates further with continued recession in 2013. The euro could rapidly fall below 1.20. A European debt default cascade is a tail risk for the single currency. Risk aversion would lead to an extended USD and JPY rally.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Chinese growth	We expect Chinese growth to land softly and then recover. Should China disappoint us with a hard landing, then we have a problem. Risk unwinding will support USD and JPY versus risk takers currencies.
European sovereign crisis, ECB policy	With Greek elections out of the way, the main focus lies on Spain and on potential ECB rate cuts. Any improvement in Spain should support the euro, a rate cut would probably hurt it. **Key dates: ECB Meetings on 5 July and 2 August**
US growth and Fed policy response	Will the Fed add QE to current Operation Twist programs? How will presidential elections change political powers in Washington? Keys to address long-term financing issues. **Key dates: 1 August, FOMC meeting; 6 November, US Presidential elections**

Recommendations

Tactical (6 months)

- Long USD, GBP and CAD
- Short EUR, and CHF

Strategic (1 to 2 years)

- We recommend investors diversify from large USD and EUR exposures into minor currencies. Structural financing issues weigh on each of the major currencies.
- The best diversifiers based on long-term macroeconomic fundamentals are the CAD and the SEK. The AUD, NOK and CHF should only be added at better entry levels.

UBS CIO FX forecasts

	25-06-12	3M	6M	12M	PPP
EURUSD	1.2485	1.22	1.28	1.32	1.31
USDJPY	79.88	83	85	90	80
USDCAD	1.0296	0.98	0.94	0.94	0.94
AUDUSD	0.9993	0.97	1.00	1.05	0.75
GBPUSD	1.5548	1.56	1.65	1.70	1.69
NZDUSD	0.7851	0.75	0.79	0.83	0.60
USDCHF	0.9617	0.99	0.95	0.93	1.01
EURCHF	1.2006	1.21	1.21	1.23	1.32
GBPCHF	1.4947	1.55	1.56	1.58	1.71
EURJPY	99.74	101	109	119	105
EURGBP	0.8026	0.78	0.78	0.78	0.77
EURSEK	8.8133	8.65	8.55	8.40	8.86
EURNOK	7.492	7.40	7.40	7.40	8.57

Source: Thomson Reuters, UBS CIO, as of 25.06.2012

Note: Past performance is not an indication of future returns.

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EM currencies

UBS View **For current exchange rates and CIO forecasts see table**

- With the risk of a Greek Eurozone exit subsiding, we think selected emerging market (EM) currencies look attractive over the medium term against the USD and JPY and some even against the EUR.
- Global growth prospects remain intact, also due to recent policy easing in China, and the risk of a broader European crisis remains contained, in our view. Over the medium term, this will likely support EM currencies. However, further bouts of volatility remain likely in the months ahead, since negative headlines from Europe will likely continue to weigh on investor sentiment.
- Our tactical and strategic recommendations list our preferred currencies. For now, we remain cautious on the Brazilian real, Hungarian forint, Indian rupee, and Turkish lira.

↗ Positive scenario **> 7% outperformance of EM FX against G4 currencies over a 6-month horizon**

- Macroeconomic data comes in stronger than expected and contagion risks in Europe subside further. EM exchange rates could appreciate swiftly against G4 currencies (USD, EUR, JPY, GBP).

↘ Negative scenario **> 4% depreciation of EM FX across regions against USD over a 6-month horizon**

- Global growth prospects suffer a prolonged deterioration and the European debt crisis intensifies further. EM exchange rates could see a significant, although likely temporary, sell-off across regions. Should growth concerns return to the fore, we expect export-oriented EM countries (e.g. most Asian economies) to welcome currency weakness in order to cushion economic growth.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Inflation dynamics in EM	Inflation dynamics are important to forecast central bank policy rate decisions. Monetary easing typically weighs on EM currencies, while rate hikes tend to be supportive. **Key policy rate announcement dates: 29 June, Colombia; 4 July Poland; 5 July, Malaysia; 11 July, Brazil; 12 July, Indonesia; 19 July, Turkey**
European sovereign crisis	Setbacks in sentiment will likely lead to bouts of EM currency depreciation and elevated volatility across regions, providing attractive entry points for investors.
US growth	Growth in the US is key for risk sentiment, growth prospects in EM, and US monetary policy decisions. Positive surprises tend to support EM currencies. **Key dates: 1 August, US ISM & FOMC rate decision**

Recommendations

Tactical (6 months)

- Several EM currencies look attractive at current levels; we advise investors to gradually increase their exposure to our preferred EM currencies, using the yen and the USD as funding currencies. Our preferred EM currencies are CNY, IDR, KRW, SGD, MXN, ZAR, CZK, and PLN.

Strategic (1 to 2 years)

- We recommend EM currencies backed by stable fundamentals as a strategy to diversify currency exposure.
- Our favorites include the Chilean peso, Czech koruna, Polish zloty, Chinese renminbi, Korean won, Malaysian ringgit and Singapore dollar.

UBS CIO EM FX forecasts

	27.06.2012	3-month	6-month	12-month
Americas				
USDBRL	2.07	2.10	1.95	1.85
USDMXN	13.8	12.7	12.5	12.3
Asia				
USDCNY	6.37	6.30	6.25	6.15
USDINR	57.1	53.0	54.0	55.0
USDIDR	9'480	9'300	9'200	9'000
USDKRW	1'157	1'130	1'110	1'050
USDSGD	1.28	1.24	1.23	1.22
EMEA				
EURPLN	4.25	4.35	4.15	4.00
EURHUF	286	305	285	310
EURCZK	25.9	26.0	25.0	24.3
USDTRY	1.81	1.75	1.78	1.78
USDZAR	8.43	7.90	7.75	7.50
USDRUB	32.9	33.5	32.0	31.0

Source: Bloomberg, UBS CIO, as of 27 June 2012

Note: Past performance is not an indication of future returns.1

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Section 2.D

Asset class views

NTAC: Commodities, Listed real estate, Hedge funds and Private equity

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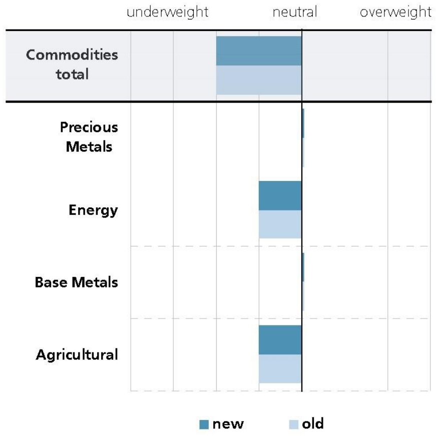
Commodities overview

Commodities – Key points

- Broadly diversified commodity indices, which declined by about 10% in May, found some support in June. The sideways move was visible across all commodity sectors, with gold (precious metals) delivering a temporary price uptick after the May US nonfarm payroll release.
- Despite signs of price stabilization, diversified **commodity indices are likely to decline** in the coming weeks. Sluggish economic activity should put upward pressure on most commodity inventories. To mitigate inventory buildups, lower prices are required, in our view. Production cuts for cyclical commodities need to be incentivized, while demand needs a push.
- The starting point for **gold** (**precious metals**) remains challenging, with supply likely to outpace demand this year. However, the chance of further monetary easing (QE3) by the Fed - which is not our base case - is an upside risk to the gold price. Given the weak fundamental situation combined with the substantial QE3 risk we maintain our neutral position.
- Easing geopolitical tensions related to Iran and further inventory builds in **crude oil** shifted the market's attention to sluggish demand growth. With muted incremental crude oil consumption, crude oil prices are likely to remain under pressure. But as production cuts are likely to kick in, downward price momentum should slow meaningfully. OPEC production cuts of up to 0.5 mbpd are needed in the coming months, and should allow the Brent price to stabilize in the USD 80.5 - 90/bbl range (WTI with a USD 12/bbl discount). But a sideways move in crude oil is not good enough to be long the commodity. The Brent forward curve has joined WTI and moved into contango as well. Hence, we keep our underweight position.
- With regards to **base metals**, prices have room to soften in the very short run (4-6 weeks). Copper prices are likely to decline to USD 6,600/mt in order to weigh on scrap supply and compensate for deteriorating Chinese import volumes. But the price decline in copper and other base metals should be short lived. Fiscal and monetary easing in China provide the basis for an acceleration in base metal demand and should keep prices largely flat on a 6-month horizon. Moreover, metals like aluminum and nickel are already trading deeply into the production cost curve, which we regard as unsustainable over the long run. We keep a neutral position on base metals until we see further confirmation of a pickup in Chinese economic activity.
- The outlook for ample supply in **agricultural commodities**, especially for corn, should still weigh on the grain complex towards the end of the year. Some short-term price support from dry US Midwest weather conditions in recent weeks is not altering our negative stance. Soft commodities are also battling with higher inventories, which will not bode well for prices in 3Q 2012.

Preferences (6 months)



Source: UBS CIO, as of 22 June 2012

Note: Past performance is not an indication of future returns.

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Precious metals

Preference: neutral

Gold (25 Jun): USD 1,573/oz (last month: USD 1,573/oz)

UBS View (gold) **6-month target: USD 1,650/oz**

- The price outlook for gold is largely tied to quantitative easing by the Fed. Although the probability has increased on weak US data, our base case still calls for no QE. Hence, current prices run on thin ice, in our view. In the absence of any monetary stimulus, the gold market is likely to be oversupplied by more than 400 tons this year.
- Physical demand out of Asia remains lackluster. With the USDINR trading at a record high, the world's second-largest gold market, India, is likely to witness a steep decline in jewelry consumption and a rather firm increase in scrap supply. Central bank buying, estimated at 300 tons (7% of total demand) in 2012, will not be enough to clear the market. Right incentives – i.e. temporary price setbacks – are needed to motivate enough demand, before prices should manage to rebound towards USD 1,650/oz in 6 months.
- The negative stance from a absolute return perspective, should not overshadow the relative attractiveness of the yellow metal. The higher probability of QE3 by the Fed poses an upside risk to the gold price. Hence, we maintain our neutral position.

↗ Positive scenario **6-month target: USD 1,920/oz**

- Additional quantitative easing measures by the US Fed and the ECB are implemented, or inflation accelerates sharply in emerging markets. This would drive the gold price towards USD 1,920/oz again.

↘ Negative scenario **6-month target: USD 1,250/oz**

- A liquidity crisis would curtail financial demand and weigh on the gold price. A similar impact would come from deflationary pressure (positive real rates), or a combined Chinese and Indian hard landing.

What we're watching	Why it matters
Physical demand/supply	Further INR weakness in the coming months should determine jewelry demand from India. The health of coin and bar demand should be visible in the **World Gold Council mid-August release**. After the drop in PGM production, keeping an eye on South African PGM output is a must.
Flows & rates	To judge gold-related financing deals, we track gold export/import between Hong Kong and China. In addition we follow the latest uptick in ETF gold holdings and futures positions in gold to proxy investment demand strength. From an opportunity-cost perspective (real interest rate standpoint), we also look at the upcoming meetings of the ECB on **5 July** and Fed on **1 August**.

Recommendations

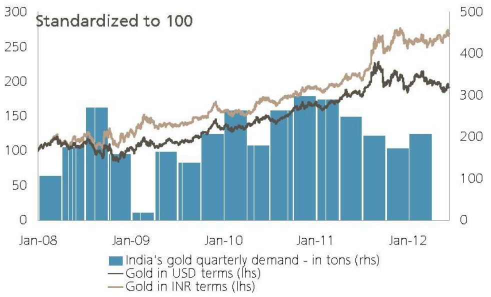
Tactical (up to 6 months)

- In case of a conversion into gold, investors should hold the position and target re-conversion at the original strike level. Over three months, we regard strike levels around USD 1,460–1,520/oz as attractive. With option volatility on the rise, the risk reward for selling volatility has improved.

Strategic (1 to 2 years)

- The risks for debt monetization in the developed world and double-digit wage growth in China and India, the two largest gold markets, should ensure a steady rise in demand for gold and platinum over time. Physically backed ETF positions allow investors to participate effectively in higher prices. Positive real interest rates present a threat to this view.

Gold in INR terms and Indian gold demand



Source: WGC, Bloomberg, UBS CIO, as of 19 June 2012

Note: Past performance is not an indication of future returns.

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Energy

Preference: underweight

Brent (25 Jun): USD 91/bbl (last month: USD 109/bbl)

UBS View (crude oil)

Brent 6-month target: USD 100/bbl

- A combination of renewed economic concerns about the Eurozone, easing geopolitical tensions between Iran and the West, and further inventory builds in crude oil triggered a sharp decline in the Brent crude oil price to USD 92/bbl and USD80/bbl for WTI.
- We think the crude oil market is oversupplied, which is likely to push up OECD crude oil inventories to 62 days of consumption in the coming months. While it seems that Saudi Arabia has slightly reduced its production in May from 10.1 mbpd in April, the country could be in a wait-and-see position for longer. First, the EU/US sanctions on Iran take effect at the end of June/early July, and bring some additional supply uncertainty. Second, Saudi Arabia also sees the need for lower prices in the short run to support economic activity in the developed world. But to prevent inventories from swelling too strongly, additional production cuts of up to 0.5 mbpd (0.55% of global demand) are needed in the coming months.
- So what should investors do at current levels? Although downward momentum in crude oil prices is likely to fade, a sideways move should still lead to negative investment returns in the short run. The Brent forward curve flipped into contango from backwardation, which is deteriorating the risk reward payoff of the energy sector. Hence, we currently maintain our underweight position.

↗ Positive scenario

Brent 6-month target: USD 140-180/bbl

- Iranian oil exports gets subject to a complete embargo, or military interventions affect crude oil supply via the Strait of Hormuz. Alternative OPEC supply routs would not be in a position to compensate for such a supply shortfall. In order to curb demand, prices would need to spike towards USD 180/bbl.

↘ Negative scenario

Brent 6-month target: USD 75-80/bbl

- Economic growth in the developed world contracts, thereby triggering a 0.5% to 1% decline in world crude oil consumption. Although to a lesser degree, fading Iranian tensions and no supply cuts by OPEC would allow crude oil inventories to build firmly and push Brent prices down towards USD 80/bbl.

What we're watching	Why it matters
Iran tensions	Resurfacing Iranian tensions could cause prices to spike higher, but an escalation is less likely, in our view. The focus is on remaining Iranian exports (currently around 1.6mbpd versus 2.4 mbpd in 2011).
Supply	US crude oil supply has come in strongly – reaching 6.4 mbpd. Further supply growth would not bode well for WTI crude oil. We also look at oil supply related to Sudan, Syria and Yemen, which caused a 0.5 mbpd decline in global crude oil production capacity. It seems that these production capabilities will remain offline for a longer period – potentially until 2014.
Oil market reports (EIA/IEA/OPEC)	**Key dates: 12 July, IEA Medium Term Oil market report.** Another round of downward revisions to demand, like in June, is not expected. The latest forecast changes to demand have been meaningful.

Recommendations

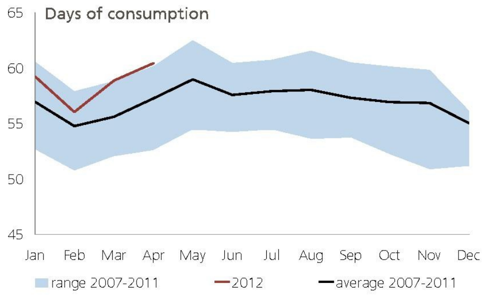
Tactical (6 months)

- We foresee further short-term weakness although less pronounced than the past month – we expect Brent to stabilize in the range of USD 80.5 - 90/bbl in the next 3 months. Production cuts and a pick up in emerging market demand should push Brent crude oil above current levels.

Strategic (1 to 2 years)

- After the demand slump in 1H 2012, we expect Brent crude oil to trade at USD 110/bbl in 12 months. This higher price level for 2013 reflects our expectation that economic activity should provide price support in 2013. Thus, three-year crude oil futures contracts at USD 90/bbl remain for us mispriced and an attractive investment solution for strategy-oriented crude oil investors.

OECD crude oil industry inventories on the rise



Source: EIA, UBS CIO as of 19 June 2012

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Base metals

Preference: neutral

Current (last month)**: copper USD 7,317/mt**(7792); **nickel USD 16,528/mt**(16833); **aluminum USD 1,825/mt**(1989)

UBS View **6-month target: copper: UDS 7,400/mt nickel: USD 18,000/mt; aluminum: USD 2,200/mt**

• With the exception of aluminum, base metal prices stabilized broadly in June. But we see room for somewhat lower prices in the short run (4-6 weeks). Deteriorating industrial activity in Asian countries, weak US data and the Euro-zone crisis remain a price burden for the sector in the early part of 3Q12.

• To weigh on scrap supply and compensated for lower Chinese copper imports, copper prices are likely to decline towards USD 6600/mt, in our view. For the rest of the base metals, prices could move deeper into the cost curve of production. When it comes to aluminum and nickel, however, prices have already declined deeply into the production cost curve. In both cases supply cuts could come quicker and limit the price downside from current levels.

• In addition, supply uncertainty related to aluminum and nickel needs to be considered as well. Indonesia's new regulations on ore exports could jack up Chinese import costs by around 20% in the coming quarters. We think such an increase would be meaningfully, as 60% of China's nickel pig iron (NPI) production and 80% of China's bauxite imports depend on Indonesia.

• The reason why base metals overall should trade at current levels or higher in six months from now, relates to China. We think the People's Bank of China has made the right monetary policy steps to achieve stronger credit activity and higher sequential GDP growth in 2H 2012. With this fairly balanced risk reward on a six-month horizon, we maintain our neutral position.

↗ Positive scenario

• China eases monetary policy aggressively, by pushing credit growth beyond 20% y/y. Additional QE in the US paired with stable European and Japanese demand would allow the sector to rally by around 25%.

↘ Negative scenario

• Chinese monetary conditions remain behind the curve, resulting in an economic hard landing. A severe escalation of the Eurozone crisis (deep recession/global impact) could also bring prices close to 2009 levels.

What we're watching	Why it matters
Demand	The latest uptick in **Chinese imports, driven by technical factors,** do not reflect stronger end demand. The June figures (**on 10 July**) should give some clarity. That said, the attractiveness to import from an arbitrage perspective SHFE to LME has improved. Interest for physically backed copper ETFs needs to be tracked as exchange inventories are structurally low.
Supply	Copper supply has room to improve in 2H 2012 from poor mine output in 1H 2012. Fading supply disruptions and capacity additions put copper at risk. Indonesia's new export rules could have a positive one-off impact on aluminum and nickel.
Economic data/forward curve	People's Bank of China meeting, Chinese economic data (especially IP and loan growth by financial institutions) **Key dates: 11–15 July**

Recommendations

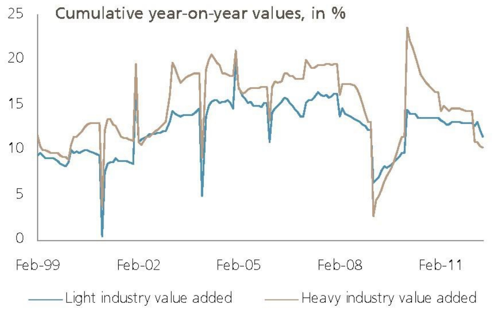
Tactical (3-6 months)

- From a timing perspective, building up exposure to base metals is not yet advised. While we still expect higher prices over the next 6–12 months, the short-term downside risks should offer investors better entry points, particularly for copper. That said, existing aluminum and nickel positions should be kept.

Strategic (>1 year)

- Rising energy and labor costs provide the backdrop for base metal prices to trend higher. The strongest performance is likely to come from zinc and lead, where existing mine capacity is expected to peak in 2014. Environmentally challenged base metals, like tin, should be in line with the sector average. For nickel and aluminum, ample production capacity should lead to an underperformance in the long run. Due to its high current price versus production costs, copper should lag too.

Heavy industrial activity in China, with high commodity use, slumped



Source: Bloomberg, UBS CIO, as of 18 June 2012

Note: Past performance is not an indication of future returns.

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Agriculture

Preference: underweight

Current (25 June) (last month)**: Soybeans, USD 14.79/bu** (USD13.82/bu); **Corn, USD 6.09/bu**(USD 5.79/bu); **Wheat, USD 6.91/bu** (USD 6.80/bu)

UBS View **6-month target: Soybeans, USD 13.5/bu; Corn, USD 5.10/bu; Wheat, USD 6.00/bu**

- Besides the overall commodity price backdrop, prevailing dry weather conditions in the US have been price supportive for the grains and added to firmer prices.
- While weather-related news flows might support grain prices in the short run (downward revisions in grain yield estimates, especially corn), the 6–12 month price outlook remains negative. Global corn inventories should grow beyond 10% in 2012/13. We think this will more than compensate for firmer wheat fundaments (lower inventory estimates) in the coming months. For soybeans, current price levels sufficiently factor in the poor supply figures seen in recent months. This would be especially true, if South American planting gets a boost due to soybeans' relative price improvement.
- A strong supply backdrop for Brazilian coffee along with a weaker BRL has kept coffee prices under pressure. For 2012/13, Brazilian coffee and sugar exports are likely to increase by 12% and 2% y/y respectively, and keep the global market well supplied in 2012. Cotton prices saw some bouts of strength, but demand has yet to work off high inventory levels at 74–75mn bales. With ample inventories and economic conditions at risk, renewed price weakness is likely.

↗ Positive scenario **Soybeans 6-month USD 16/bu**

- Lower acreage and yield figures for the US can tighten the supply backdrop until 1Q 2013 (until the new South American crop comes). On the demand side, higher soybean use for bio diesel in Argentina and strong Chinese imports (improvements in crush margins) are catalysts for prices to rally.

↘ Negative scenario **Soybeans 6-month USD 12/bu**

- Unexpected Chinese government stock sale of soybeans and deteriorating crushing margins for soybean oil/meal production, would leave soybean prices vulnerable to a price correction.

What we're watching	Why it matters
USDA WASDE report (monthly)	US corn yields could be at risk in the upcoming WASDE release. **Key date : 11 July 2012**
Grains stock report (quarterly)	Corn and soybean inventories could be lowered vs. current estimates, reflecting the strong export activity in corn during March–May and higher soybean crushing during the same period. **Key date: 28 September 2012**
USDA crop progress (weekly, Monday)	Dry weather conditions in the US has impacted the crop conditions (rating), which deteriorated in recent weeks.
COT (weekly, Friday)	Investors have scaled back their long exposure in corn. At the present speed, net positions would close in on zero over the next two months.

Recommendations

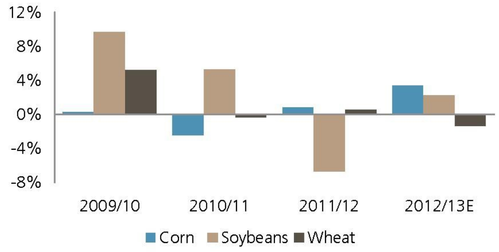
Tactical

- The forward curve in corn already factors in a steep decline by the end of the year, thereby mitigating the expected negative return. With lower corn prices, wheat should come under pressure as well. Most agricultural commodities are generally well supplied, so unless the weather surprises on the downside, we expect further weakness.

Strategic

- Strategic agricultural positions are not recommended at present. Our return outlook for the grains stands at –7.5% to – 5% over the next 12 months. Although the softs have a positive return outlook over the same period, investors should bide their time. Short-term price setbacks of 10% or more are still likely over the next two to three months.

Global corn surplus as % of demand to advance towards 5-year high



Source: USDA, UBS CIO, as of 18 June 2012

Note: Past performance is not an indication of future returns.

UBS

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Listed real estate

Preference: neutral

UBS Global Index DTR (28 June): 1,375 (last month: 1,320)

UBS View

UBS Global Index DTR (6-month target): 1,400

- A slight positive monthly performance has been driven by rebounds in the higher beta markets, respectively Hong Kong, Japan and Singapore.
- Listed real estate is still attractively valued on different earnings ratios and trade on a slight discount to NAV. Earnings yields over 5 year swap rate are attractive currently attractive, yet the flattening of interest curves has come to a halt and we see less support from it in the future.
- Little supply of commercial space across the globe leads vacancy rates to gradually decline and low capitalization rates in core markets support capital values. Also rental yields remain attractive compared to high grade bond yields. However, further significant capital appreciation is unlikely. This is especially due a slow down in rental income as economic growth is subdued. Hence, future performance is limited.
- Although slightly reduced, we maintain our preference for US REITs due to stable fundamentals and like Australia as a conservative play. We slightly overweight Hong Kong, stay neutral towards Singapore, but maintain a slight underweight in Japan as fundamentals remain unconvincing.

↗ Positive scenario

UBS Global Index DTR (6-month target): 1,500

- Improving macroeconomic data in the US, positive economic surprises in Europe followed by monetary easing in China help to increase growth prospects that support rental income growth, while refinancing costs remain low in a low inflation environment. Real estate offers a comparatively attractive yield.

↘ Negative scenario

UBS Global Index DTR (6-month target): 1,300

- The US growth path disappoints investor expectations and causes the comparatively high valuation levels there to correct, significantly affecting global real estate. Furthermore, a more severe recession in Europe triggers a tightening of credit standards, making listed real estate more dependent than ever on bank financing at a time when credit markets are already fragile. Real estate underperforms global equities because the correlation between the availability of credit and short-term performance is high.

Note: Scenarios refer to global economic scenarios (see slide 7)

What we're watching	Why it matters
Capitalization rates and rental yields	We do not expect capitalization rates to decrease much from now. Rental yields have already been pushed down by decreasing bond yields; we see a diminishing support from the interest curve, which has significantly flattened in the past.
Transaction volumes and future rental growth in direct markets	Global commercial real estate transaction volumes are down year-on-year due to a lack of product in core markets and constraints on debt financing. Global rental growth has softened and very modest growth will feature major markets overall.
Credit markets and financing costs	Lending conditions have been a little tightened. However, well financed listed companies have still good access to credit, while others are more restricted.

Recommendations

Tactical (6 months)

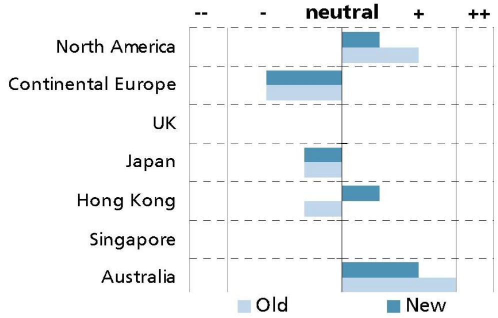
- We maintain our neutral stance towards listed real estate after a good performance year-to-date and due to a relative less attractive valuation compared to global equities. Going forward returns are limited by subdued revenue growth. However, we still expect listed real estate to stay comparatively attractive in a low growth, low rates environment.

Strategic (1 to 2 years)

- A cyclical slowdown in rents limits growth, but attractive refinancing conditions are supportive. We see potential for higher payout ratios in the US and Asia, while Europe has to consolidate balance sheets.

Preference (6 months)

Our market preferences for listed real estate*



* This is our relative preference within the global real estate sector based on UBS Global Real Estate Index domestic total return, which is not the overall sector view

Source: UBS CIO, as of 26 June 2012

Note: Past performance is not an indication of future returns.

For further information please contact CIO's asset class specialist Thomas Veraguth, thomas.veraguth@ubs.com

Hedge funds

UBS View **Prefer Relative value and Event-driven**

• We expect hedge funds (HF) to offer positive asymmetric returns characteristics vs. the S&P 500 due to active management and stop-loss strategies. (HF were down 1.9% in May 2012 vs MSCI world at –8.5%)

• Decelerating global growth prospects, the next leg in the ongoing Eurozone crisis, is challenging mostly equity long-short managers, who are net-long the market. While event-driven managers share some of the performance drivers, idiosyncratic bets (event) reduce the exposure to markets. The real reason to own this strategy, however, is the potential for out-sized return in distressed, high yield and other credit investments as the Eurozone crisis plays out. The inherent hedging in relative-value should remain appealing. Credit relative-value managers should perform well in this environment of higher fixed income volatility and increasing pricing anomalies created by central bank interventions (OT2) and limited competition.

↗ Positive scenario **Prefer Equity long-short**

• A reduction of uncertainty (e.g. resolution in Europe) lowers equities' correlation and volatility. This helps bottom-up fundamental analysis and equity long/short managers the most. Also, CEOs will likely make more corporate transactions that can be monetized by event-driven managers, and a clearer macroeconomic environment with more persistent trends would be supportive for macro managers

↘ Negative scenario **Prefer Trading (Global Macro + CTA)**

• A 2011-type scenario in which hedge fund managers get whipsawed through the year with risk-on and risk-off circumstances, driven by a multitude of political interventions, is difficult to anticipate. That would impact long-short managers, event-driven, and to a lesser extent global macro managers.

Note: Scenarios refer to global economic scenarios (see slide 7)

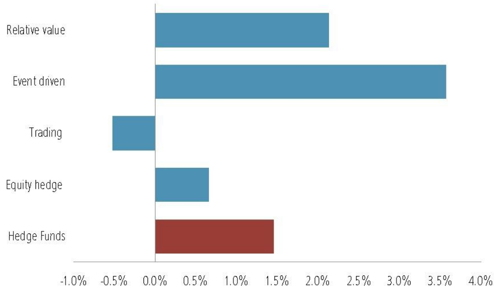
What we're watching	Why it matters
Global equity direction / economic cycle	The outlook for global equities becomes an important HF performance driver. The economic cycle impacts the strategies differently.
Correlation	Correlation among pair-stocks; an important performance/alpha driver for equity long/short, the largest HF strategy by assets under management.
Leverage	Gross and net leverage are key to monitoring risk.
Volatility	The direction influences certain HF strategies (e.g. convertible arbitrage).
Liquidity	Particularly for large HF that are less nimble to enter and exit their strategies
Regulation	Volcker's rule, USCITS III/IV

Recommendations

Strategic (1 to 2 years)

- Active risk management is instrumental for capital preservation during adverse market conditions. At the moment, we therefore favor relative value and event-driven strategies, since they are less hinged to equity markets and other risky assets than trading is.
- Value proposition: Hedge funds should achieve robust performance over an extended horizon, while displaying limited volatility vis-à-vis equities and other risky assets, in general. Hedge funds minimize downside losses in adverse market conditions (e.g. active risk management) and play a crucial role in wealth appreciation, since there is less ground to regain in the recovery phase and ultimately greater chances for superior long-term returns.

Performance (year-to-date)



Source: HFRI, UBS CIO, as of 18 June 2012

Note: Past performance is not an indication of future returns.

For further information please contact CIO's asset class specialist Cesare Valeggia, cesare.valeggia@ubs.com

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Private Equity

Prefer small/mid-cap buyout in US / emerging markets; distressed debt in Europe

UBS View

- Private equity deals in today's volatile and uncertain markets are conservatively financed, with an average equity cushion of 40%. We like mid-market buyout strategies, which offer long-term exposure to attractive corporate assets and which rely less on large bank debt syndications.
- Our house view sees large parts of Europe in a stagnation, and business owners are reluctant to sell their companies, reducing PE deal flow in the region significantly. We therefore prefer North America, which will see continuous (albeit suboptimal) growth, and emerging markets, which show positive fundamentals.
- Prices for PE transactions have corrected by around 10% this year, although they are still 20% above the attractive levels seen during the successful years between 2000 and 2004. However, significant dry powder and high cash positions at corporations keep competition high and hinder prices from falling much further.

↗ Positive scenario

Prefer small-/mid-cap buyout and secondaries

- An abating Eurozone debt crisis and improved business confidence would increase deal flow and exit opportunities for private equity managers, but would also increase entry prices. In such a positive scenario, we would perceive commitment strategies to secondary funds as attractive for building exposure to an invested private equity portfolio.

↘ Negative scenario

Prefer distressed debt

- A renewed escalation of the debt crisis would significantly impact deal activity, the availability of debt and company owners' willingness to sell. At the same time, it would offer attractive opportunities within distressed strategies and lower entry prices for long-term private equity investors.

Note: Scenarios refer to global economic scenarios (see slide 7)

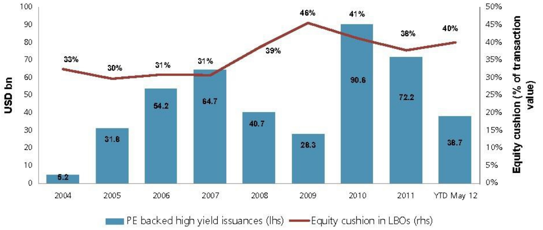
What we're watching	Why it matters
Credit markets	Availability of leverage and credit spreads are important signs of the health of buyout markets. Small/mid caps are currently financed at 4.3x EBITDA (vs 4.6x for large-caps) and are more attractive given their lower reliance on bank financing in a period of ongoing bank deleveraging.
Capital overhang	We track deal/exit activity to understand the pressure to invest, future price dynamics and draw-down profiles for investors. More than USD 930bn of un-invested capital and expiring investment periods will keep prices elevated.
Purchasing prices (Enterprise value / EDITDA)	Price multiples offer valuable insight into private company valuations. YTD May 2012, buyouts occurred at 8.1x, down from 8.8x seen in 2011. Large-cap buyouts have come down 10% from the peak last year to 8.6x.

Recommendations

Strategic (1 to 2 years)

- We prefer small-/mid-cap buyouts in North America given the better economic outlook vs Europe, higher transaction certainty and more attractive entry prices.
- Investors looking for downside protection and stability during economic uncertainties can consider large-cap buyouts in the US, which offer exposure to large, diversified companies at more attractive prices.
- In Europe, the crisis and ongoing deleveraging have led to attractive opportunities for special situations. We thus recommend investing in distressed debt to benefit from the macroeconomic adjustment process and selling pressure for many European banks.
- We advise investors make an ongoing allocation to private equity in emerging markets, which offer an attractive way to capture superior long-term growth and provide access to small/mid-cap companies not available through the stock market.

Private equity deals continue to be defensively financed amidst economic uncertainty



Source: S&P, UBS CIO, as of May 2012

Note: Past performance is not an indication of future returns.

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Note: We emphasize the equal importance of fund manager selection and the commitment strategy. Please note that private equity is an illiquid asset class and must be held at least until the end of the fund (10+ years). Please note that UBS might not have a product available which reflects our UBS CIO private equity recommendations. Private equity is only suitable for qualified investors (> USD 5m investable assets).

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UBS

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PROGRAMME FOR THE PRESIDENT AND FIRST LADY FOR
THE 67th UNITED NATIONS GENERAL ASSEMBLY
22-29 SEPTEMBER
NEW YORK

Saturday, 22 September 2012

02.15 PM: **President Arrives In JFK**

- *Flight # EK 201*
- *Composition of the motorcade.*
  - *Car 1: President + First Lady*
  - *Car 2: PR + Counsellor Javed*
- *Departs to Helmsley Hotel, 42nd street between 2nd and 3rd Ave*

08.00 PM – 10:30 PM: **Private Dinner**

- *Helmsley Hotel*

Sunday, 23 September 2012

08:00 AM – 09:00 AM: **Breakfast with Maldivian Delegates**

- *Helmsley Hotel*

12:30 PM – 01:30 PM: **Private Lunch**

- *Helmsley Hotel*

02.10 PM – 2.25 PM: **Bilateral with the Secretary- General.**

- *Location: 3rd Floor NLB, UNHQ (Walking distance)*
- *President+ Foreign Minister + State Minister + AG+ PR+ Aliny*

08.00 PM – 10:30 PM: **Private Dinner Event – Jeffrey Epstine**

- *Composition of the motorcade.*
  - *Lead car: President*

Monday, 24 September 2012

8:00 AM – 9:30 AM: **Breakfast with Maldivian Delegates**

- *Helmsley Hotel*

10.00 AM – 05.00 PM: **High Level Segment on Rule of Law**

- *Location: UN Headquarters. (Walking distance)*
- **20th speaker, apprx 11.40 am**
- *President+ Foreign Minister + State Minister + AG+ Ambassador Rasheed +PR*

12:30 PM – 01:30 PM: **Private Lunch**

- *Helmsley Hotel*

04.00 PM- 04.45 PM: **UNDP Administrator.**
- *Location: bilateral booth at the UN.(Walking distance)*
- *President+ Foreign Minister + Environment Minister + AG + Ambassador Rasheed + PR*

06.15 PM: **Depart Hotel to President Obama's Reception**

07.00 PM: **President Obama's Reception**
- *Location: Starlight Roof, The Waldorf Astoria Hotel, 301 Park Avenue, New York*
- *President + First Lady*

08.00 PM – 11:00 PM: **Private Dinner**
- *Helmsley Hotel*

Tuesday, 25 September 2012

7:00 AM – 7:30 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

07.30 AM: **Depart from Hotel to UNHQ (Walking distance)**

08.00 AM – 08.50 AM: **Welcoming reception hosted by the Secretary-General**
- *Location: Indonesian Lounge, UNHQ*
- *President + First Lady*

09.00 AM: **Opening of the General Assembly**
- *Location: UNHQ*
- *President+ Foreign Minister + Environment Minister + AG + State Minister+ PR*

01.15 PM: **Luncheon in honour of Heads of State hosted by the Secretary -General**
- *Location: Visitors Lobby, UNHQ*
- *President*

03.00 PM- 03.35 PM: **Executive Director of UN-Women, Ms. Bachelet.**
- *Location:* 220 East, 42nd Street, 19th Floor.
- *President+ State Minister + Environment Minister + AG+ Nee*

04.00 PM: **Tea Reception hosted by Mrs. Ban Soon-taek for spouses.**
- *Location: SG's Residence, 3 Sutton Place and 57th Street.*
- *First Lady*

04.45 PM- 05.15 PM: **UNICEF Executive Director, Anthony Lake**
- *Location:* UNICEF Building, 13th Floor
- *President+ Foreign Minister + State Minister + Ambassador Rasheed + PR +Aliny*

06.00 PM – 07.30 PM: **Reception hosted by Prime Minister of Australia**
- *Location: Ambassador's Riverview, UN Headquarters*

- *President + Foreign Minister + PR*

08.00 PM – 11:00 PM: **Private Dinner**
- *Helmsley Hotel*

Wednesday, 26 September 2012

8:00 AM – 9:00 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

9.00 AM – 11.00 AM: **Museum Tour hosted by Mrs Ban Soon-taek**
- *Location: Morgan Library 225 Madison Ave. + 36th street*
- *First Lady*

09.30 AM- 11.00 AM: **2012 Launch of the Climate Vulnerability Monitor**
Invitation received from Prime Minister of Bangladesh
- *Location: Asia Society, 725 Park Avenue (at 70th Street)*
- *President + Foreign Minister + Environment Minister+ PR*

11.30 AM- 12.00 PM: **Tanzania Foreign Minister**
- *Location: bilateral booth at the UN.(Walking distance)*
- *President +Foreign Minister + State Minister+ AG + PR+ Aliny*

01.15 PM – 03.00 PM: **South Africa Reception, hosted by the President of South Africa**
- *Location: Ambassador's Riverview, UN Headquarters.*
- *President+ Foreign Minister + PR*

03.00 PM- 03.30 PM: **Trinidad and Tobago Foreign Minister**
- *Location: bilateral booth at the UN.(Walking distance)*
- *President + Foreign Minister + State Minister + Amb Rasheed + PR + Aliny*

04.15 PM – 05.00 PM: **Meeting with Commonwealth Secretary General, H.E Mr. Kamalesh Sharma.**
- *Location: Commonwealth Joint Office Large Conference room.*
- *President+ Foreign Minister + State Minister + AG+ PR+ Aliny*

05.00 PM: **Visit to the Permanent Mission of Maldives**
- *Location: 800 2nd Ave. 4th Floor*
- *President+ Entire Delegation*

06.00 PM – 08.00 PM: **Reception hosted by Luxembourg, in honor of His Royal Highness Grand Duke Henri. (TBC)**
- *Location: Permanent Mission of Luxembourg, Luxembourg House, 17 Beekman Place, NY 10022*
- *President + PR*

08.30 PM: **Cyprus: Musical Philoxenia hosted by the President of Cyprus**
- *Location: Alice Tully Hall, Starr Theater, 1941 Broadway on 65th street.*
- *President+ PR+ FM+ Spouses*

11.00 PM – 12:00 AM: **Private Dinner**
- *Helmsley Hotel*

Thursday, 27 September 2012

8:00 AM – 9:00 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

09.00 AM- 09.30 AM: **Vanuatu Prime Minister**
- *Location: bilateral booth at the UN.(Walking distance)*
- *President + Foreign Minister+ State Minister +AG+ PR +Aliny*

09:00AM – 11:30AM **Fifth Annual World Focus on Autism**
- *Location: The Prestigious Roosevelt House*
- *First Lady*

10:00AM – 11:30AM **Feed the Future: Partnering with Civil Society hosted by the President of Malawi and Hillary Clinton.**
- *Location: The Empire Room, Waldorf Astoria, 301 Park Ave.*
- *President, Foreign Minister and PR*

12:30 PM – 01:30 PM: **Private Lunch**
- *Helmsley Hotel*

03.00 PM – 09.00 PM: **General Debate**
- *Location: General Assembly, UN Headquarters*
- Approx. 4 pm
- *President+ Foreign Minister + State Minister + AG+ PR+ Ali Rasheed*
- *Maldives has the 4th speaking slot.*

03.00 PM – 06.00 PM: **2nd AOSIS Leaders Summit**
- *Location: Helmsley Hotel*
- *President+ Environment Minister + Hassan*

06.30 PM: **Sierra Leone Foreign Minister**
- *Location: bilateral booth at the UN.(Walking distance)*
- *President +Foreign Minister + State Minister+ AG + PR+ Aliny*

06.30 PM – 08.30 PM: **Reception hosted by Nauru (Chair of AOSIS)**
- *Location: Helmsley Hotel*
- *President+ Environment Minister + PR*

08.30 PM – 11:00 PM: **Private Dinner Event**
- *Helmsley Hotel*

Friday, 28 September 2012

8:00 AM – 9:00 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

09.00 AM – 10.30 AM: **CMAG Meeting**

- *Location: Australian Mission*
- *President*

12.15 PM- 12.45 PM: **President of the General Assembly**

- *Location:* GA 200 (Behind GA Hall) UNHQ
- *President+ Foreign Minister+ PR+ Aliny*

04.00 PM: **OHCHR**

- *Location: TBC*
- *President+ AG*

06.00 PM – 07.30 PM: **Commonwealth Reception hosted by Australia. (TBC) (RSVP)**

- *Location:1 Beekman Place, New York, NY 10022*
- *Head of Delegation + Foreign Minister +PR*

08.00 PM – 11:00 PM: **Private Dinner**

- *Helmsley Hotel*

Saturday, 29 September 2012

8:00 AM – 9:30 AM: **Breakfast with Maldivian Delegates**

- *Helmsley Hotel*

1.45 PM: **President Depart from JFK to LAX (TBC)**

- *Flight #AA 117*
- *Composition of the motorcade.*

Itinerary of President Waheed and Madam Ilham

EK	**659**	**21SEP**	**MLE/DXB**	**1000**	**1300**	
EK	**201**	**22SEP**	**DXB/JFK**	**0830**	**1415**	
AA	**117**	**29SEP**	**JFK/LAX**	**1345**	**1655**	
EK	**216**	**5OCT**	**LAX/DXB**	**1645**	**1935**	** Arriving 06th October

PROGRAMME FOR LOS ANGELES SEGMENT
29TH SEPTEMBER – 5TH OCTOBER
NEW YORK

Saturday, 29 September 2012

04.55 PM: **HEP Arrives In LAX**
  - *Flight # AA 117*
  - *Extended Port Courtesies*

7.00 PM: **Dinner at Navarro's house**
  - *Sstay at Shilo Hilltop Suites Hotel or alternative*

Sunday, 30 September 2012

xxx **Sail to Catalina Island, stay in Avalon (several hotels to choose from)**
  -

Monday, 1 October 2012

xxx **Explore Avalon, 2nd night in Avalon**
  -

Tuesday, 2 October 2012

Xxx **Sail or motor to another part of the island and return to Avalon, 3rd night in Avalon**
  -

Wednesday, 3 October 2012

xxx **Sail back to Newport Beach, Stay in Anaheim, close to Disneyland (several hotels to choose from)**
  -

Thursday, 4 October 2012

xxx **Disneyland, 2nd night in Anaheim**
  -

Friday, 5 October 2012

04.45 PM: **HEP Departs LAX**
  - *Flight # EK 216*
  - *Extended Port Courtesies*

Updated on 20 September 2012

PROGRAMME FOR 67th UNITED NATIONS GENERAL ASSEMBLY
18 SEPTEMBER – 20 DECEMBER 2012
NEW YORK

Friday, 21 September 2012

08.30 AM: **Working Breakfast hosted by Ireland, Mary Robinson**
- *Location: One Dag Hammarskjold Plaza, 885 2nd Ave. 19th floor*
- *PR*

03.00 PM: **Shabeen's Arrival**
- *Location: JFK*
- *Flight # QR 83*

Saturday, 22 September 2012

02.15 PM: **President Arrives In JFK**
- *Flight # EK 201*
- *Composition of the motorcade.*
  - *Car 1: President + First Lady*
  - *Car 2: PR + Counsellor Javed*
- *Departs to Helmsley Hotel, 42nd street between 2nd and 3rd Ave*

06.47 PM: **H.E. Mohamed Rasheed Arrives**
- *Flight #UA 81*
- *Received by Javed*

08.00 PM – 10:30 PM: **Presidents Private Dinner**
- *Helmsley Hotel*

Sunday, 23 September 2012

08:00 AM – 09:00 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

12:30 PM – 01:30 PM: **Presidents Private Lunch**
- *Helmsley Hotel*

02.10 PM – 2.25 PM: **Bilateral with the Secretary- General.**
- *Location: 3rd Floor NLB, UNHQ (Walking distance)*
- *President+ Foreign Minister + State Minister + AG+ PR+ Aliny*

06.00 PM: **South-South Awards**

- *Location: The Waldorf Astoria Hotel, 301 Park Avenue, New York*
- *PR*

08.00 PM – 10:30 PM: **Presidents Private Dinner Event – Jeffrey Epstine**
- *Composition of the motorcade.*
  - *Lead car: President*

Monday, 24 September 2012

8:00 AM – 9:30 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

08.15 AM – 10.00 AM: **Peaceful Settlement of Conflict, hosted by Netherlands (TBC)**
- *Location: Delegates Dining Room, UN Headquarters.*
- *Foreign Minister*

10.00 AM – 05.00 PM: **High Level Segment on Rule of Law**
- *Location: UN Headquarters. (Walking distance)*
- **20th speaker, apprx 11.40 am**
- *President+ Foreign Minister + State Minister + AG+ Ambassador Rasheed +PR*

12:30 PM – 01:30 PM: **Presidents Private Lunch**
- *Helmsley Hotel*

01.15 PM – 02.45 PM: **High Level Lunch Event on Women's Access to Justice, hosted by UN Women, HoD of Finland and South Africa (TBC)**
- *Location: Ambassador's Riverview, UN Headquarters.*
- *AG*

02.00 PM- 02.30 PM: **Jamaica Foreign Minister (Confirmed)**
- *Location:* TBC
- *Foreign Minister*

03.00 PM- 06.00 PM: **High-level meeting on sustainable energy for all. (Confirmed)**
- *Location*: NLB 2 UNHQ.
- *Environment Minister+ Di (Speaking slot 10)*

04.00 PM- 04.45 PM: **UNDP Administrator.**
- *Location: bilateral booth at the UN.(Walking distance)*
- *President+ Foreign Minister + Environment Minister + AG + Ambassador Rasheed + PR*

06.15 PM: **Depart Hotel to President Obama's Reception**

07.00 PM: **Obama's Reception (Confirmed)**
- *Location: Starlight Roof, The Waldorf Astoria Hotel, 301 Park Avenue, New York*
- *President + First Lady*

08.00 PM – 11:00 PM: **Presidents Private Dinner**
- *Helmsley Hotel*

Tuesday, 25 September 2012

7:00 AM – 7:30 AM: **Breakfast with Maldivian Delegates**
  - *Helmsley Hotel*

07.30 AM: **Depart from Hotel to UNHQ (Walking distance)**

08.00 AM – 08.50 AM: **Welcoming reception hosted by the Secretary-General**
  - *Location: Indonesian Lounge, UNHQ*
  - *President + First Lady*

09.00 AM: **Opening of the General Assembly**
  - *Location: UNHQ*
  - *President+ Foreign Minister + Environment Minister + AG + State Minister+ PR*

11.30 AM – 12.00 PM: **Meeting with Commonwealth Deputy Secretary General, Mrs. Mmasekgoa Masir- Mwamba. (Confirmed)**
  - *Location: Commonwealth Joint Office Large Conference room.*
  - *State Minister+ Aliny+ Di*

01.15 PM: **Luncheon in honour of Heads of State hosted by the Secretary -General**
  - *Location: Visitors Lobby, UNHQ*
  - *President*

03.00 PM- 03.35 PM: **Executive Director of UN-Women, Ms. Bachelet.**
  - *Location:* 220 East, 42nd Street, 19th Floor.
  - *President+ State Minister + Environment Minister + AG+ Nee*

03.30 PM: **Shiaan arrives in JFK**
  - *Flight # BA 1588*
  - *…………..*

04.00 PM: **Tea Reception hosted by Mrs. Ban Soon-taek for spouses.**
  - *Location: SG's Residence, 3 Sutton Place and 57th Street.*
  - *First Lady*

04.00 PM- 04.30 PM: **Canada Foreign Minister (Confirmed)**
  - *Location:* TBC
  - *Foreign Minister*

04.30 PM- 05.00 PM: **U.K, Allister Burt (Confirmed)**
  - *Location:* TBC
  - *Foreign Minister*

04.45 PM- 05.15 PM: **UNICEF Executive Director, Anthony Lake**
  - *Location:* UNICEF Building, 13th Floor
  - *President+ Foreign Minister + State Minister + Ambassador Rasheed + PR +Aliny*

06.00 PM – 07.30 PM: **Reception hosted by Prime Minister of Australia**
- *Location: Ambassador's Riverview, UN Headquarters*
- *President + Foreign Minister + PR*

EVENING **UN Secretary General Ban Ki-moon's Every Women Every Child reception (TBC)**
Venue: New York Museum of Modern Art
Rishfa: please provide details!

08.00 PM – 11:00 PM: **Presidents Private Dinner**
- *Helmsley Hotel*

Wednesday, 26 September 2012

8:00 AM – 9:00 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

09:00 AM – 10:00 AM: **Deepening Democracy: A Strategy for Improving the Integrity of Elections Worldwide**
- *Location: One UN plaza, Riverview room 28th floor*
- *……*

9.00 AM – 11.00 AM: **Museum Tour hosted by Mrs Ban Soon-taek**
- *Location: Morgan Library 225 Madison Ave. + 36th street*
- *First Lady*

09.30 AM- 11.00 AM: **2012 Launch of the Climate Vulnerability Monitor**
Invitation received from Prime Minister of Bangladesh
- *Location: Asia Society, 725 Park Avenue (at 70th Street)*
- *President + Foreign Minister + Environment Minister+ PR*

11.30 AM- 12.00 PM: **Tanzania Foreign Minister**
- *Location: bilateral booth at the UN.(Walking distance)*
- *President +Foreign Minister + State Minister+ AG + PR+ Aliny*

01.15 PM – 03.00 PM: **South Africa Reception, hosted by the President of South Africa**
- *Location: Ambassador's Riverview, UN Headquarters.*
- *Head of Delegation+ Foreign Minister + PR*

01:15 PM – 02:30PM **LDC Agenda in a Post Rio+20 Perspective**
- *Location: NLB 2, UNHQ*
- *Ministerial Level*

01:15 PM – 02:30PM **Freedom of Religion or Belief: An Individual's Choice**
- *Location: NLB 3, UNHQ*
- *Ministerial Level*

03.00 PM- 03.30 PM: **Trinidad and Tobago Foreign Minister**
- *Location: bilateral booth at the UN.(Walking distance)*
- *President + Foreign Minister + State Minister + Amb Rasheed + PR + Aliny*

03.00 PM- 06.00 PM: **Parliaments and the Rule of Law: Toward Justice for**

All, Organized by IPU(Confirmed)
- *Location:* Conference room 3 NLB, UNHQ
- *Nihan+ AG+ Shabeen*

04.15 PM – 05.00 PM: **Meeting with Commonwealth Secretary General, H.E Mr. Kamalesh Sharma.**
- *Location: Commonwealth Joint Office Large Conference room.*
- *President+ Foreign Minister + State Minister + AG+ PR+ Aliny*

05.00 PM: **Visit to the Permanent Mission of Maldives**
- *Location: 800 2nd Ave. 4th Floor*
- *President+ Entire Delegation*

06.00 PM – 08.00 PM: **Reception hosted by Luxembourg, in honor of His Royal Highness Grand Duke Henri. (TBC)**
- *Location: Permanent Mission of Luxembourg, Luxembourg House, 17 Beekman Place, NY 10022*
- *President + PR*

06.00 PM – 08.00 PM: **Reception hosted by E.U, Inaugurating new premises. (TBC)**
- *Location:666 Third Avenue, 31st floor, NY 10017*
- *Foreign Minister+ Javed*

06.30 PM – 08.30 PM: **Reception hosted by U.A.E, hosted by the Minister of Foreign Affairs of U.A.E (TBC)**
- *Location: Morgan Library and Museum, 225 Madison Ave.*
- *Environment Minister*

08.30 PM: **Cyprus: Musical Philoxenia hosted by the President of Cyprus**
- *Location: Alice Tully Hall, Starr Theater, 1941 Broadway on 65th street.*
- *President+ PR+ FM+ Spouses*

11.00 PM – 12:00 AM: **Presidents Private Dinner**
- *Helmsley Hotel*

Thursday, 27 September 2012

8:00 AM – 9:00 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

08.00 AM – 09.30 AM: **Increase Peace through Mediation, co-hosted by Finland and Turkey (TBC)**
- *Location: Consulate General of Finland, 866 United Nations Plaza, Suite 250, New York, NY*
- *Ministerial Breakfast*

09.00 AM- 09.30 AM: **Vanuatu Prime Minister**
- *Location: bilateral booth at the UN.(Walking distance)*
- *President + Foreign Minister+ State Minister +AG+ PR +Aliny*

09:00AM – 11:30AM **Fifth Annual World Focus on Autism**

- *Location: The Prestigious Roosevelt House*
- *First Lady*

10:00AM – 11:30AM **Feed the Future: Partnering with Civil Society hosted by the President of Malawi and Hillary Clinton.**

- *Location: The Empire Room, Waldorf Astoria, 301 Park Ave.*
- *President, Foreign Minister and PR*

10.00 AM- 10.45 AM: **Palestine Foreign Minister (Confirmed)**

- *Location:* Booth Requested
- *Foreign Minister+ PR+ Javed+ Nee*

10:00 AM – 01:00 PM: **The Civil Society and the Education on Human Rights**

- *Location: NLB 5, UNHQ*
- *AG+ Shabeen+ Javed+ Nee+ Di*

11:00AM – 01:30 PM: **High-Level launch of United Nations Guidance for Effective Mediation**

- *Location: 821 UN Plaza 8th floor*
- *Foreign Minister*

12:30 PM – 01:30 PM: **President Private Lunch**

- *Helmsley Hotel*

03.00 PM – 09.00 PM: **General Debate**

- *Location: General Assembly, UN Headquarters*
- Approx. 4 pm
- *President+ Foreign Minister + State Minister + AG+ PR+ Ali Rasheed*
- *Maldives has the 4th speaking slot.*

03.00 PM – 06.00 PM: **2nd AOSIS Leaders Summit**

- *Location: Helmsley Hotel*
- *President+ Environment Minister + Hassan*

06.30 PM: **Sierra Leone Foreign Minister**

- *Location: bilateral booth at the UN.(Walking distance)*
- *President +Foreign Minister + State Minister+ AG + PR+ Aliny*

06.30 PM – 08.30 PM: **Reception hosted by Nauru (Chair of AOSIS)**

- *Location: Helmsley Hotel*
- *President+ Environment Minister + PR*

06.30 PM – 08.30 PM: **Reception hosted by Indonesia (TBC) (Need to RSVP)**

- *Location: 325 East 38th Street, New York, NY 10016*
- *Foreign Minister + PR*

06.30 PM – 08.30 PM: **Art for Reconciliation, reception hosted by Georgia**

- *Location: Bohemian National Hall, 321 East 73 street NY 10023*
- *PR*

08.30 PM – 11:00 PM: **Presidents Private Dinner Event**

- *Helmsley Hotel*

Friday, 28 September 2012

8:00 AM – 9:00 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

09.00 AM – 10.30 AM: **CMAG Meeting**
- *Location: Australian Mission*
- *President*

10.00 AM: **H.E. Mohamed Rasheed, Departure**
- *Flight #UA 755*

09.00 AM – 01.15 PM: **High- Level meeting on Countering Nuclear Terrorism**
- *Location: GA Hall, UN Headquarters.*
- *PR*

12.15 PM- 12.45 PM: **President of the General Assembly**
- *Location:* GA 200 (Behind GA Hall) UNHQ
- *President+ Foreign Minister+ PR+ Aliny*

01.15 PM – 03.00 PM: **Climate Change and their impact on foreign and security policy, hosted by Germany and Kingdom of Morocco.**
- *Location: TBC*
- *PR*

04.00 PM: **OHCHR**
- *Location: TBC*
- *President+ AG*

06.00 PM – 07.30 PM: **Commonwealth Reception hosted by Australia. (TBC) (RSVP)**
- *Location:1 Beekman Place, New York, NY 10022*
- *Head of Delegation + Foreign Minister +PR*

08.00 PM – 11:00 PM: **Presidents Private Dinner**
- *Helmsley Hotel*

Saturday, 29 September 2012

8:00 AM – 9:30 AM: **Breakfast with Maldivian Delegates**
- *Helmsley Hotel*

09.00 AM – 04.00 PM: **Commonwealth Foreign Ministers Meeting**
- *Location: Helmsley Hotel*
- *Foreign Minister +PR*

01.45 PM: **President Depart from JFK to LAX**
- *Flight # AA 117*
- *Composition of the motorcade.*

07.00 PM: **Delegation Depart from JFK**
- *Flight # DL82*

- …………

11.40 PM: **Shabeen's Departure**
- *Location: JFK*
- *Flight # QR 84*

Monday, 1 October 2012

10.00 AM- 06.00 PM: **Forum of Small States (FOSS) Conference on Small States**

Location: UN North Lawn Building, Conference Room 3
FM+PR

Around 04.00 PM: **Singapore Foreign Minister (Confirmed)**
- *Location: on sidelines of FOSS, UN North Lawn Building, Conference Room 3*
- *Foreign Minister*

Tuesday, 2 October 2012

10.00 AM- 10.30 AM: **Bilateral Meeting with H.E Ms. Heidi Hautala, Minister of International Development of Finland (Confirmed)**
- *Location:* Booth Requested
- *Foreign Minister+ Aliny +PR+ Nee*

1.00 PM: **SAARC Informal Luncheon/ Meeting**
- *Location: Helmsley Hotel*
- *Foreign Minister +PR*

11.00 PM: **Minister of Foreign Affairs depart from JFK**
- *Flight # EK 202*

Thursday, 4 October 2012

11.20 AM: **Aliny's Departure**
- *Location: JFK*
- *Flight # EK 204*

Incoming Requests

TBC: **Christian Mission for the United Nations Community (TBC)**
- *Requesting a meeting with HEP*

Between 24th & 29th Sep: **Bilateral with Georgia Foreign Minister (TBC)**
- *Location: TBC*
- *Foreign Minister*
- *Contact: Ms. Neli Shiolashvili, Tel: 212 759 1949 Email:n.shiola@gmail.com*

TBC: **Publisher & Editor PODER Magazine (TBC)**
- *Requesting a meeting with HEP*

24-28 September **Bilateral Meeting with H.E Mr. Kim Sung- Hwan, Minister of Foreign Affairs of South Korea**

Updated on 20 September 2012

Contact: Mr. Ileung Kim, First Secretary, PM/Korea
212-439-4087, iekim99@mofat.go.kr
Ms. Sun A Yoon, 212-439-4059, yoons.rok.un@gmail.com

Bilateral Requests sent

His Excellency the President (22 September – 29 September 2012)

- **India**
- **Sri Lanka**
- **Pakistan**
- **Nepal**
- **Bangladesh**
- **Afghanistan**
- **Bhutan**
- **Australia**
- **Canada (not available)**
- **China**
- **Japan**
- **USA**
- **Germany**
- **Denmark**
- **World Bank**

His Excellency Dr. Abdul Samad Abdulla, Minister of Foreign Affairs (22 September – 5 October 2012)

- **United States**
- **Russia, (Informed not possible)**
- **Turkey,**
- **Malaysia,**
- **UAE**

Her Excellency Dr. Mariyam Shakeela, Minister of Environment and Energy

- **Sri Lanka**
- **Clinton Foundation**

Her Excellency Aishath Azima Shakoor, Attorney General (22 September – 29 September 2012) (Delegates attending Rule of Law Meeting)

- **Australia,**
- **Canada,**
- **UK**
- **World Bank** ***(if attending Rule of Law Meeting)***

Eye on the Market | October 22, 2012 J.P.Morgan

The most important energy developments of 2012: how countries are planning for Independence Day

First, a few updates:

- It looks like sub-2.5% global GDP growth is showing up in the weak outlook provided by some **bell-weather cyclical companies** that reported so far (AMD, APD, BHI, CAT, ETFC, GE, GOOG, IBM, MCD, MSFT, PH). We're about to see how resilient an equity market is when one of its key selling points is how expensive bonds are. The recent pick-up in leading indicators suggests that earnings expectations may stabilize early in the new year.
- September US retail sales were strong and US **housing** data continue to improve, although as noted last week, the degree of housing's contribution to growth remains the big question. There will be economic headwinds next year even if the fiscal cliff is negotiated down. See October 9th EoTM for the full Monty on the fiscal cliff mechanics.
- We modeled the **President's tax proposals** on various demographics of high net worth taxpayers[1]. The results: increases in effective tax rates (as % of adjusted gross income) from 4% to 12%, depending on income, investible assets, stock-bond ownership, state of domicile, etc. It's unlikely to be enacted as scripted unless there's a Democratic sweep, but its contours probably indicate where HNW taxation is eventually heading. We don't have enough info to analyze Romney's tax plan in comparable detail. On the latter, the Tax Policy Center released a study indicating that capping itemized deductions at $25k for all taxpayers only offsets 32% of the estimated revenue loss from a 20% reduction in income tax rates.
- Production, capital spending and export data from **China** show improvement from the weak pace over the summer, although details reveal a continued decline in manufacturing growth offset by rising gov't infrastructure spending. China ran a 600 billion RMB budget *surplus* through September, and targets an 800 bn RMB budget *deficit* this year. I wouldn't argue that all that gov't spending is going to have a huge productivity benefit, but it should keep things moving. Chinese earnings growth and business climate surveys remain weak, an unsurprising consequence of excess industrial capacity.
- In **Europe**, financial markets continue to rally in the Periphery. Five -year Spanish credit spreads have fallen below 3% from over 6% last July, and without the ECB firing a single shot (e.g. buying any bonds). The economic data is still bad (a collapse in auto sales similar to 2009), but now it's just "run-of-the-mill" terrible instead of "look-out-for-that-bank/country-it's-about-to-default" terrible. What is impossible to assess: the ability of Southern Europe to withstand rising social and political pressures of massive unemployment. Also: watch out for France, where there is a large, growing economic gap vs. Germany, and where its President is resisting German demands for centralized budgetary supervision.

Our annual energy discussion with Vaclav

Every year, I sit down with Vaclav Smil from the University of Manitoba to discuss "the year in energy". Vaclav is one of the world's foremost experts on energy issues, and has written over 30 books and 300 papers on the subject. In this note, we walk through what Vaclav identified as the 5 notable energy developments of 2012[2]: **energy independence initiatives in the US, Europe and Japan; geopolitical implications of rising Chinese oil demand; and another rough year for the electric car**.

The political backdrop in the Middle East, European concerns about natural gas dependence on Russia, and lingering concerns about nuclear power after Fukushima are factors driving countries to seek greater energy independence. In the US, prospects for energy independence rely mostly on domestically produced oil and natural gas, while in Europe and Japan, they rely on rising renewable energy targets. What's remarkable is the official sector confidence in Germany and Japan that the transition cost to renewables will be manageable. One indicative data point: the cost of building connections between offshore wind farms and the electricity grid (*excluding* the cost of the wind turbine itself) can be greater than the cost of building an entire brand new natural gas plant. As always, a renewable energy discussion involves facts, figures, emotion and a large dose of the unknown.

The outcome will have important consequences for growth, the cost and availability of electricity and the global balance of payments. These developments argue for greater growth and productivity potential in the US, although energy costs are just one part of the larger economic and profits equation. Even among US manufacturing companies, energy generally represents only 5% of total expenses, and is dwarfed by labor costs.

Michael Cembalest
J.P. Morgan Asset Management

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[1] **Proposed changes affecting U.S. high net worth taxpayers**: increased tax rates on ordinary income, dividends and realized capital gains; increased Medicare taxes on earned and unearned income; rising limitations on itemized deductions (state & local taxes, mortgage interest and charitable deductions); partial inclusion of municipal income, 401k contributions and employer-paid health benefits in taxable income.

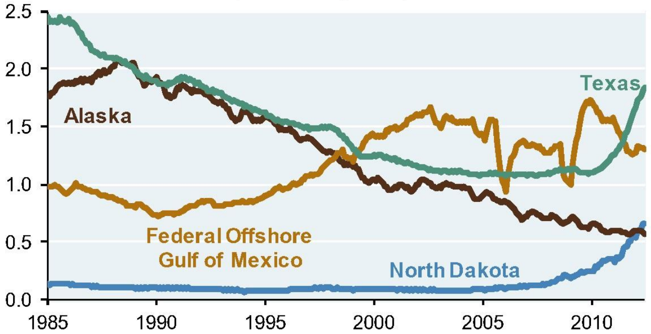
[2] Other items we could have discussed: continued growth of global hydropower, politics around the Keystone XL pipeline, the apparent end of Exxon's collaboration with Craig Venter to develop fuels from genetically modified algae, and the EU's decision to deemphasize crop-based biofuels due to concerns about greater carbon emissions than the diesel they replace, and high food prices.

The most important energy developments of 2012: how countries are planning for Independence Day

I: What might US energy independence look like?

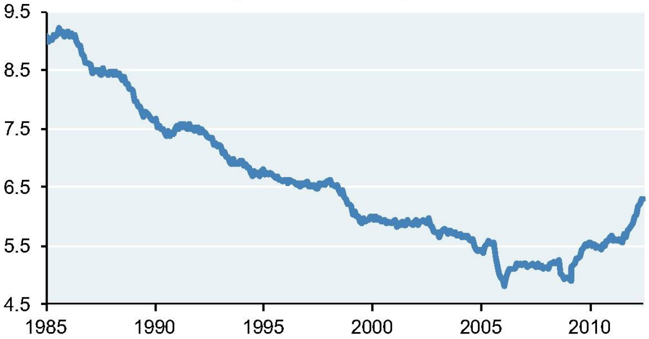
Rising crude oil production in Texas and North Dakota has contributed to a reversal of the long-term US production decline. The latest data (June 2012) show North Dakota now ahead of Alaska's North Slope.

Crude oil production by region
Million barrels crude oil production per day



Source: US Energy Information Administration.

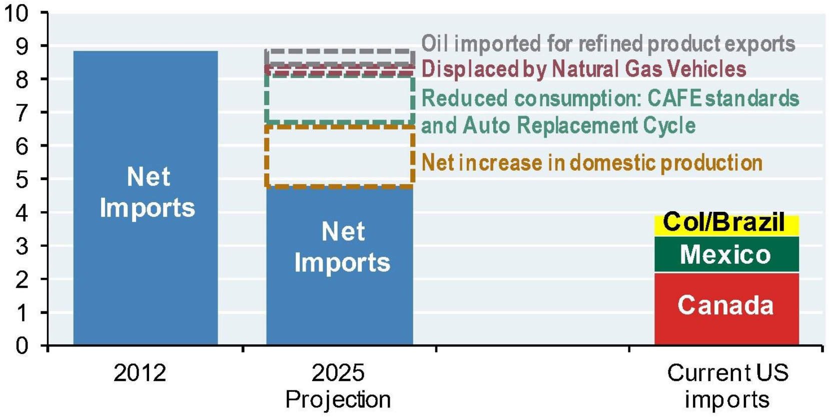
Total US crude oil production
Million barrels crude oil production per day



Source: US Energy Information Administration.

The growth in US domestic production is notable, but on its own insufficient to result in energy independence since the US still imports ~9 mm bpd of oil. But when combined with other factors affecting demand and supply, the concept of energy independence comes into view over the next couple of decades. **What is "energy independence"?** After some adjustments (and I may be underestimating some of them), US net imports could fall to 4-5 mm bpd, a level which can be met by imports from countries with historically reliable economic and political linkages to the US (everything is relative). The point is not that reduced US crude imports will lower oil prices; countries like China with growing oil needs may offset that. **What matters here are the economic and geopolitical benefits from (a) not having to design military and foreign policy objectives based on energy security to the degree the US has over the last 30 years[3], and (b) being able to reap the growth, employment and current account benefits of domestically sourced-oil and natural gas.**

What US energy independence might look like
US net crude oil imports, million barrels per day



Source: US Energy Information Administration, JPMAM.

For a review of the assumptions in this chart, see page 3; otherwise, skip to page 4.

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[3] See "*Addicted to Oil: Strategic Implications of American Oil Policy*" from the Strategic Studies Institute of the U.S. Army. The piece outlines 4 pillars to U.S. national interests: defense of the homeland, promotion of U.S. democratic values, creation of a favorable world order, and enhancement of the nation's economic well-being. According to the authors, each has been negatively impacted by US demand for foreign oil. They believe that U.S. foreign policies that support repressive oil states are diametrically opposed to American values, and reversed the 20th century trend of the U.S. fighting against totalitarianism and in favor of liberty, and in turn caused the U.S. to lose the "war for ideas" that is critical to wining the "war on terror".

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Some detail on the components of increased US energy independence:

Net increase in domestic production: we have modeled an increase of 1.8 mm bpd. For context, the 2012 Energy Information Administration (EIA) outlook has a variety of crude oil production scenarios for 2025 ranging from no increase to an increase of 2.8 mm bpd (the "technically recoverable resource" case). Any production increase from current levels is expected to come from "tight oil", extracted from formations such as Bakken and Eagle Ford, and the Permian Basin. While conventional crude production volumes in the Gulf may rise, these are expected by the EIA to offset declines elsewhere (Alaska). The EIA's optimism is matched by a June 2012 paper from Leonardo Maugeri at Harvard's Kennedy School, which projects a US crude oil increase of 2.6 mm bpd by 2020. An illustrative quote[4]:

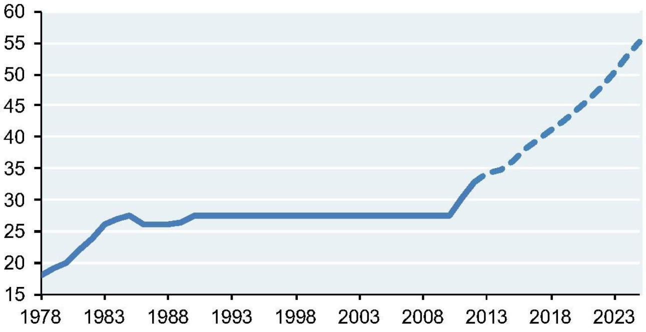
> "**The shale/tight oil boom in the United States is not a temporary bubble, but the most important revolution in the oil sector in decades**. It will probably trigger worldwide emulation over the next decades that might bear surprising results - given the fact that most shale/tight oil resources in the world are still unknown and untapped.… Thanks to the technological revolution brought about by the combined use of horizontal drilling and hydraulic fracturing, the US is now exploiting its huge and virtually untouched shale and tight oil fields, whose production – although still in its infancy – is already skyrocketing in North Dakota and Texas."

Regarding the Bakken shale, Maugeri's estimate of 300 billion barrels of oil in place are exceeded by larger mean estimates from USGS geochemist Leigh Price and Continental Resources.

Reduced consumption due to higher CAFE standards and the automobile replacement cycle: this is a topic that generates a lot of debate and technical discussion about driving patterns, but this much is clear: CAFE standards and the ongoing replacement of older cars will improve the fuel efficiency of the future fleet. The Union for Concerned Scientists has estimated the benefit of CAFE at 3 million barrels of oil per day by 2030, while the Administration's estimate is 2.2 million by 2025. The average 11-year age of US cars is at the highest level on record, up from 8.5 years in 1995. While some of this increase reflects cars with improved lifespans, it also reflects the impact of the recession and pent-up demand to replace older cars. As a result, our estimate of 1.5 mm bpd in oil consumption savings seems reasonable in context.

Corporate Average Fuel Economy standards

Miles per gallon, passenger cars



Source: National Highway Traffic Safety Administration.

Impact of rising penetration of natural gas vehicles: The rationale for natural gas vehicles (NGV) stems from a price per million BTUs for oil that's 5x higher than natural gas. The US NGV penetration rate is low, in part due to the chicken/egg problem of the lack of natural gas refueling stations, and a more limited driving range (natural gas tanks generally hold less energy than diesel tanks). But the economics of NGVs are becoming more compelling for taxis, vans and buses that are centrally fueled with limited ranges, and for trucks with established routes where refueling stations can be built every 300-400 miles. Such heavy-duty vehicles account for 17% of all petroleum usage in the US. An example: a heavy duty 18-wheeler might travel 60,000 miles per year and get 5 mpg (using 12,000 gallons of diesel fuel). Assuming a $1.5 difference between diesel and liquid natural gas prices, a trucking company could save ~ $18,000 in annual fuel costs. The conversion cost to LNG (liquid natural gas) of $70,000 would imply a 4-year payback period, which is short in the scheme of energy trade-offs. We assume a very modest NGV penetration rate of 3%, which translates into reduced oil consumption of 0.3 mm bpd.

Oil imported for export purposes: in 2011, the US exported 0.5 mm bpd in refined petroleum products. As a result, part of the current crude oil import tab is simply for re-export, and is not part of the country's domestic consumption requirement.

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[4] "*The Unprecedented Upsurge of Oil Production Capacity and What It Means for the World*", Leonardo Maugeri, Belfer Center for Science and International Affairs, Harvard Kennedy School, June 2012. See sections 5-9 for a discussion of how shale and tight oil are gradually replacing conventional sources, how hydraulic fracking works, a detailed examination of the Bakken Shale, how EIA and USGS data are backward-looking and underestimate potential growth, the challenges for the US refining industry which has invested in the ability to process heavy-sour imports rather than light-sweet oil from shale, pipeline needs and a range of environmental issues. Maugeri was Senior Executive Vice President of Strategies and Development at ENI, and Executive Chairman of Polimeri Europa, ENI's petrochemical branch.

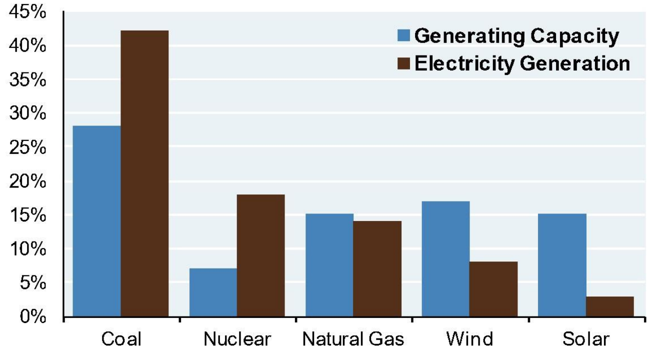
The most important energy developments of 2012: how countries are planning for Independence Day

II: Is Germany making an impetuous mad dash into renewable energy?

In the wake of Fukushima, Chancellor Merkel announced a plan to accelerate the closure of coal and nuclear power plants, with the goal of relying more on renewable energy to fill the gap. Germany is by far the largest user of electricity in Europe and its manufacturing to GDP ratio is high, so the consequences may be substantial. To get a sense of the potential impact, start with the first chart on Germany's current generating capacity and output by source. While wind and solar installations have increased in recent years, their electricity output is less impactful due to wind and solar intermittency.

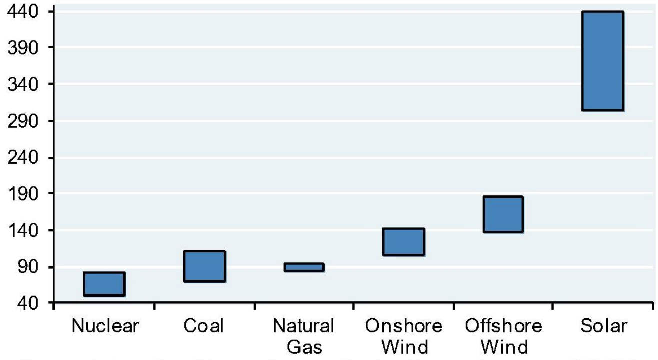
The two largest increases in Germany's renewable plan are offshore wind and photovoltaic (solar). Offshore wind connections are *very* expensive; according to Netherlands-based transmission system operator TenneT, they work out to ~1.1 million Euros per MW, and **that's just for the connection** (not the wind turbine itself, that's extra). That offshore wind connection cost is even higher than the 0.8-1.0 million per MW upfront capital cost of building new natural gas plants, using data from RWE AG (Essen) and SWB AG (Bremen). Wind is free and natural gas isn't, so we should look at **all-in levelized costs**[5] by electricity source. As shown in the second chart, all things considered, offshore wind is a very expensive way for Germany to generate electricity, and solar is higher by another order of magnitude. The relative ordering is similar in other countries.

Snapshot of current German capacity and generation
Percent of total



Source: BDEW Bundesverband der Energie- und Wasserwirtschaft e.V.

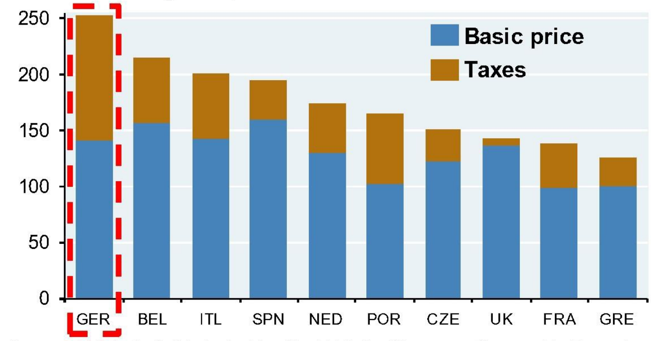
Levelized cost of electricity production in Germany
USD/MWh



Source: International Energy Agency, Nuclear Energy Agency and OECD.

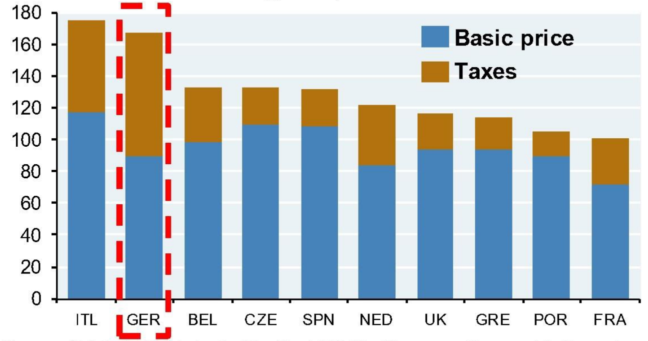
Germany is a very energy-efficient country, and has among the lowest electricity-to-GDP ratios in Europe. **However, the cost of electricity to industrial consumers is already among the highest in Europe when including taxes, and for residential consumers, Germany is the highest**. As a result, the proposed shift to renewable energy may further increase electricity prices for both residential and commercial users. There's not enough data yet to measure the impact so far.

Average retail electricity price in 2011: residential segment, EUR/MWh



Source: Wirtschaft & Infastruktur GmbH & Co Planugs - Renewable Energies.

Average retail electricity price in 2011: commerial/industrial segment, EUR/MWh



Source: Wirtschaft & Infastruktur GmbH & Co Planugs - Renewable Energies.

Germany's goal: raise the contribution of renewable energy from 20% to 35% by 2020, and to 80% of total consumption by 2050. The total cost of financing this transition is estimated at 800 billion Euros by DIW Berlin. The first stage, from now until 2020, is supposed to cost 200 billion Euros. At a time when commitments to save Spain and the rest of the Periphery are adding up, it is unclear how Germany will accomplish all of its goals simultaneously. That's probably why the ECB has been doing the heavy lifting in the European bailout: that approach doesn't look like it will cost Germany any money (yet…..)

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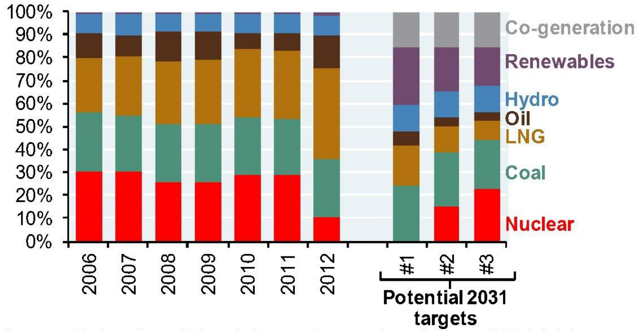
[5] Levelized costs are all-in costs which include construction, financing costs, ongoing maintenance and operations and fuel inputs costs. In Europe (unlike in the US), levelized cost numbers also include a carbon footprint estimate @ $30 per tonne of CO_2.

A brief comment on investment opportunities in wind. A recent offshore wind farm project in Germany entailed a fixed sale price contract for electricity at a guaranteed rate of 119 Euros per MWh for 13 years. This compares to 45-50 Euros per MWh for electricity in shorter term German power markets. The investor takes operational and maintenance risks, and the risk of wind's intermittency. With a large gap between the contract price and the spot market, there may be a "windfall" (sorry) for investors. **However, wind investment risks have at times been under-appreciated**. In a May 2012 report from Standard & Poor's, the authors note that they had initially rated 7 portfolio and single-asset wind projects as investment-grade. All but one has since fallen below investment-grade, which S&P states is a result of "wind resource deficiency" (wind levels below what industry experts had cited as lower-bound estimates), and higher-than-expected operating and maintenance costs (repairing cracked foundations, jack-up rigs to fix gearboxes and blades, etc). On the latter point, S&P indicates that U.S. wind project O&M costs stabilized at rates that were 30% to 40% higher than forecast.

III: Inherit the Wind: Japan's energy dilemma after Fukushima

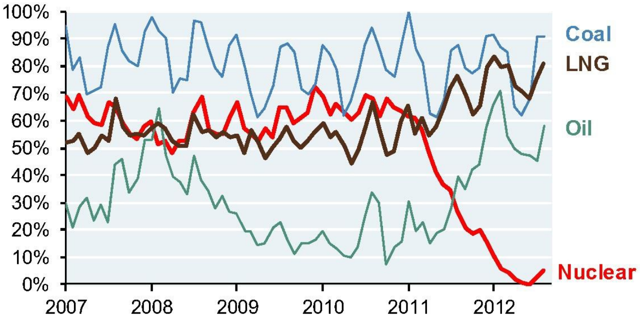
Among the challenges Japan has faced in the wake of the tsunami and nuclear meltdown, one of the greatest relates to energy policy. Only 2 of its 54 nuclear reactors are now operating. While Japan may turn some back on temporarily, it expects to decommission all of them within 18 years. Like Germany, Japan plans to increase contributions from renewable energy. Japan's plan entails increases in offshore wind, geothermal power, biomass and tidal power. The government's preferred plan as described by the METI Advisory Committee in September 2012 is #1 in the first chart, which entails no nuclear power by 2031.

Contribution to Japan power generation
Percent



Source: Federation of Electric Power Companies of Japan, METI Advisory Committee.

Japan power plant capacity utilization by fuel type
Percent



Source: Federation of Electric Power Companies of Japan 2012 Electricity Review, J.P. Morgan Commodities Research.

The first thing to note is that Japan has been able to withstand the reduction in operating nuclear plants through a sharp increase in electricity produced by natural gas plants, and oil-burning plants. However, as shown above in the 2nd chart, utilization rates of plants using LNG are rising close to maximum capacity. Consider as well the fact that Japan pays as much as 5 times more per BTU for its natural gas than the US. As a result, Japan is facing a near-term decision: turn on more nuclear power plants, import more LNG or suffer the growth penalty from higher electricity costs resulting from less supply. For a country that is already suffering from low growth and declining exports, this would be a steep price to pay.

As for Japan's long-term renewable energy plan, it is starting from a lower base than Germany: in 2011 only 1.25% of electricity came from renewable energy other than hydro (which supplied ~9%). The largest single component of its renewable energy plan relies on offshore wind. Japan's Institute of Energy Economics estimates that offshore wind levelized costs might be only 35% higher than onshore, but Japan has limited experience in both. What may be more relevant is the experience of the United Kingdom. In a recent auction run by Ofgem (Britain's electricity and gas market regulator), participants were asked to bid on a contract to build connections to offshore wind farms. Using Ofgem's estimated transfer values, **just the cost of building the connection** for offshore wind farms to the grid is ~$1.05 million per megawatt (MW). As in Germany, this is a bit higher than the UK Department of Energy and Climate estimate for an *entire* new 850-MW combined cycle natural gas plant.

For manufacturing-heavy Germany and Japan, a future based heavily on offshore wind and solar will be a brave new world of yet-to-be-determined cost and complexity. According to Vaclav, **the "entire green thing is desirable and very much worth doing, but at a measured realistic pace commensurate with overall system conditions and requirements, not guided and propelled by naive, unrealistic expectations and impossible goals"**.

Bottom line: China has a long history of economic, political and military co-operation with Iran. China has greater economic linkages with the US, but for China, that fact does not negate the advantages of its relationship with Iran, particularly as its energy needs continue to rise, and as it seeks to prevent U.S. domination of the Persian Gulf.

V: Another rough year for the electric car

Forecasts of greater electric car penetration have been around since the 1970's. A report by The National Regulatory Research Institute in 1980 aggregated various studies, which predicted 1.2 mm units in use in the US by 1983, 3 mm by 1990, 5 mm by 1995, 6.2 mm by 1998 and 13 mm by 2000. Instead, only 2.5 mm have been sold since 1999, and this mostly includes hybrids, which are not true plug-in electric vehicles (most use regenerative braking for short distance trips). Since 2010, only 50,000 highway-capable plug-in electric vehicles have been sold in the US, less than 0.03% of all vehicles. For decades, scientists have projected battery breakthroughs using nickel-zinc, iron-air, nickel-air, as well as combinations of zinc with chlorine or air and sulfur with sodium or lithium. Progress has been slow. Affordable mass-produced electric cars are still on the drawing board.

- Toyota cancelled plans for sales of eQ vehicles, claiming that the current capabilities of electric vehicles do not meet society's needs. Toyota planned to sell 40,000 plug-in hybrids in Japan this year; only 8,400 have been sold so far
- After receiving a $529mm loan from the US government, Fisker developed and built the Karma in Finland. Its battery failed during the Consumer Reports test drive, and Fisker subsequently recalled all of its 2012 Karma batteries
- A123 Systems, Inc., maker of the recalled lithium-ion battery used in the Karma and recipient of a $249mm Federal grant in 2009, filed for bankruptcy protection on October 16, 2012
- Tesla cut their delivery targets for 2012 from 5,000 to 2,700-3,250 due to production issues
- The Chevy Volt is the most successful electric car in the US, but only 16,400 have been sold this year through September, vs the goal of 45,000 that was set by the Department of Energy. Sales of the Nissan Leaf in the US are down 28% vs 2011.

If you have gotten this far, I hope you enjoyed our annual energy issue. See you next year, when it will be the 40th anniversary of *Soylent Green*, in which Edward G Robinson rides a bicycle to power a lamp so he can read a book.

Michael Cembalest
J.P. Morgan Asset Management

Biography

Vaclav Smil is a Distinguished Professor Emeritus in the Faculty of Environment at the University of Manitoba in Winnipeg and a Fellow of the Royal Society of Canada. His interdisciplinary research includes the studies of energy systems (resources, conversions, and impacts), environmental change (particularly global biogeochemical cycles), and the history of technical advances and interactions among energy, environment, food, economy, and population. He is the author of more than thirty books and more than three hundred papers on these subjects and has lectured widely in North America, Europe, and Asia. In 2010 he was noted by Foreign Policy magazine as #49 on its list of the 100 most influential thinkers in the world.

Sources, and there sure were a lot of them

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The most important energy developments of 2012: how countries are planning for Independence Day

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ELECTRON
CAPITAL PARTNERS LLC

Global Utility White Paper

A Primer on Long/Short Investing in the Global Utilities & Infrastructure Sector

Jos Shaver
Portfolio Manager
Electron Capital Partners LLC

March 08, 2013

For exclusive of Jeffrey Epstein

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For exclusive of Jeffrey Epstein

1. Executive Summary

This White Paper discusses Electron Capital's ("Electron") views on the global utility sector and outlines why now is a particularly advantageous time for long/short investing in the sector using Electron's research approach that focuses on structural change.

Electron's 5 investment professionals, working together an average of 6 years, have generated a 7-year track record of long/short investing in the global utility sector. Returns have annualized 10.3% and have been characterized by strong alpha generation (80% of returns; Jensen's alpha calculation) in a dismally-performing global sector (-0.2% absolute).

Electron will continue its approach with the **Electron Global Fund, an absolute return product**. (See Appendices 1 and 2 for Electron's process and the sector's history.)

Electron invests in a deep universe of utility and infrastructure stocks, comprising 375 companies with a market cap of $2.8 trillion. Our approach is truly global as 40-60% of the portfolio's historical gross has been allocated outside the US. Stocks covered include the electric, gas, water and waste utilities in addition to infrastructure companies (defined as those levered to utilities or utility-like). For the sake of simplicity, the rest of this White Paper will focus on the electric utilities, the largest subsector; we refer to this subsector when we reference "utility".

- **Advantageous time to be long/short investing in the global utility sector (Section 2)**.
    - Structural change in the sector has been accelerating after a recession-induced slowdown.
    - Long-only investors are not positioned for such structural change in what is the world's most underweight sector.
    - We believe hedge fund investors have already begun to make this turn as evidenced by a significant increase in net exposure over the last 6 months.

- **Structural changes will drive the largest alpha opportunities in all major regions (Section 3).**
    - US utilities will face the strongest headwinds, yet structural change will occur which will drive alpha opportunities. We believe the most interesting US structural changes will have a magnified effect internationally given commodity interlinkages.
    - European and Asian utilities offer the most abundant and attractive alpha opportunities.
    - Japan and Latam will be more trading markets over the near term.

- **Some structural changes will have a global impact (Section 4)**.
    - The shale gas and coal price washout (with its knock-on effect on global power prices) is largely over; the global utility sector has substantial optionality to any increase in power prices due to natural gas and coal prices, which will be heavily influenced by trends in the US.
        - On the supply side, US spot gas at $3.42/mmbtu is below the breakeven full-cycle natural gas production cost of $3.50-4.00/mmbtu. We believe this provides downside protection to the current gas price despite the proliferation of shale gas.
        - Potential additional demand for natural gas is enormous:
            - In the US power sector (37% of demand), EPA mandates will force coal plant closures (e.g. potentially adding 10% to natural gas demand) and increase the marginal switching cost for the most efficient plants to $4/mmbtu, providing a runway for structurally higher gas demand/prices.
            - Other large potential structural sources of demand arise from LNG exports (also 10% of US demand), a gas-intensive industrial renaissance (also 10%), and substitution of LNG/CNG for oil-based vehicle fuels.

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        - Leverage to higher power prices can be substantial. For example, in the US every $1/mmbtu improvement in natural gas prices increases Exelon's long-term earnings by more than 20%, whereas for pure generators such as NRG the leverage exceeds 30%.
        - In Europe, where power is generated at close to cash production cost in many markets, even a modest (e.g. 10%) combination of changes in coal, carbon and Euro prices can have a 25-50% earnings impact on several European utilities.
    - Global utility capex (ex-US) is rebounding after a recession-driven slowdown:
        - System-enhancing transmission capex is accelerating in Europe and Asia and is firm in the US.
        - US, European and Asian utilities are building much of the infrastructure needed to capitalize on the global shale gas boom underway.
        - In emerging markets, infrastructure spending is occurring across the entire value chain.

- **Substantial alpha opportunities follow periods of underperformance (Section 5)**.
    - Current MSCI World Utility Index underperformance against the MSCI World Index is the deepest (-67%) and longest (4 years) of the modern utility era, caused by a perfect storm of factors (see page 15).
    - Despite the strong rally in equity markets since the depths of the financial crisis, the global utility sector is still down -11% in absolute terms and has underperformed the second-worst sector (telecom) over the same period by -23%. Previous periods of underperformance have set the stage for substantial alpha opportunities driven by fundamental investors re-entering the sector.
    - The global utility sector does not need to outperform for Electron to generate solid performance; 80% of our 7-year return (10.3% per annum) is from alpha (Jensen's alpha calculation).

- **Investing in the global utility sector does not mean taking undue interest rate risk (Section 6)**.
    - The interest rate sensitivity of the sector has declined steadily since the modern utility era began in the early 1990s. US utilities remain the most interest rate-sensitive companies regionally.
    - We track interest rate risk for all positions in our risk model, and the portfolio's net interest rate risk is kept within acceptable limits as we select stocks. In addition, **Electron's return correlation to interest rates historically is slightly lower than the HFRI Equity Hedge Index's return correlation to interest rates.**
    - This process has worked well for us as Electron has posted strong returns and alpha generation in both increasing and declining interest rate environments.

- **Investors should always have an allocation to the global utility sector.**
    - This is a large-cap, dividend-generating sector that is vitally important to national economies, and which is subject to undercurrents of deregulation and competition. This has produced ample long/short opportunities in the past and will continue to do so for the foreseeable future.
    - Moreover, **an allocation to global utilities provides a diversification benefit to investor portfolios**. The risks affecting a global utility sector fund are very different from those affecting other long/short funds and diversification enables higher returns per unit of risk. Electron's 7-year track record correlation to the S&P 500 and HFRI Equity Hedge indices is .41 and .68, respectively (.18 and .55, respectively, in down markets).

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2. Structural Change – Advantageous Time for Global Utility Sector Long/Short Investing

The high level of structural change occurring around the globe makes this a particularly advantageous time to be long/short investing in the global utility sector. The various examples for each region, the importance of structural change to each region and the opportunities are listed in Section 3.

- Structural Change in Electron's Research Process

  Since the original Electron was formed in 2004, Electron's research process has focused on structural change to determine its impact on the underlying future earnings potential of our companies (see Appendix 1, page 22). Whenever there is structural change, distortions and inefficiencies arise. These invariably result in **both winners and losers among utility stocks**, in large part because of the heavy influence of public policy on the sector (e.g. governments and regulators). Policymakers will never want to knowingly provide windfall profits to utilities; if a structural change is producing a winner, we look for the loser. If a loser cannot be found, we keep looking: the loser will eventually surface.

- Structural Change Cycle

  As cycles are an important feature of life, so are cycles of structural change important in the global industry. During the recession **following the financial crisis, the activity level of structural change did slow down around the globe**. This is not surprising as governments, regulators and other stakeholders slowed the pace of structural change (i.e. a hunkering down mentality took hold among utility stakeholders) and companies slowed their rate of capital spending (because of uncertain economic growth prospects). As time has passed, the outlook for global growth has stabilized, tail risks have been managed and confidence has returned, and companies have begun spending previously-delayed capex needed to ensure system reliability. This collectively has prompted utility stakeholders to pick up the pace of structural change. Given that we track structural change globally, we estimate that this **inflection point of increased structural change occurred approximately 12-18 months ago**.

- Investors Not Positioned for Structural Change Pickup

  That we are at an inflection point for a **pickup in structural change is underappreciated** by the market. Moreover, it is occurring at a time when there are fewer eyes focused on global utilities. The underappreciated pickup in structural change activity levels combined with low investor involvement **spells opportunity for the Electron Global Fund** as it plays to the Electron team's competitive advantage. This driver was critical to the investment professionals' decision to re-launch the independent Electron.

  - Long-Only Investors Substantially Underweight but Hedge Funds Turning

    The global utility sector is the **world's most-underweight sector by a large margin**. Moreover, the underweighting has dipped to a comparably extreme level only 4 times (including now) over the last 10 years. Each time this extreme has been crossed, over the next 24 months global utilities rose by 38% on an absolute basis and outperformed the global broad market by 20%, on average.

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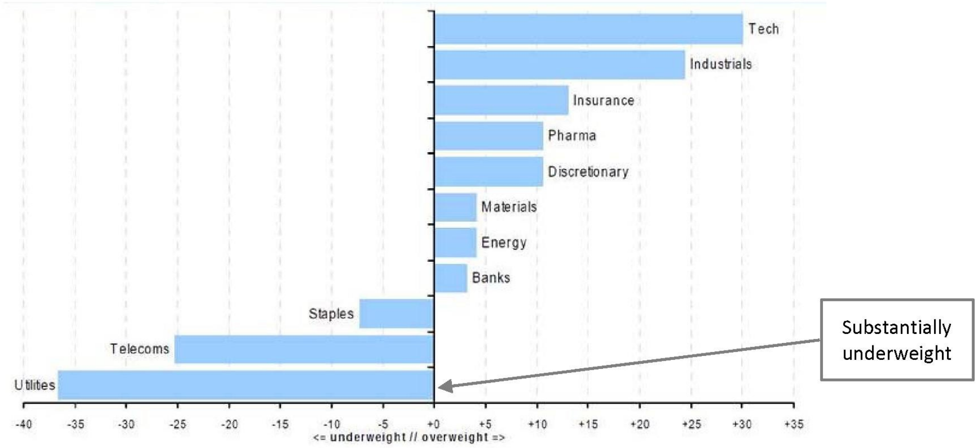
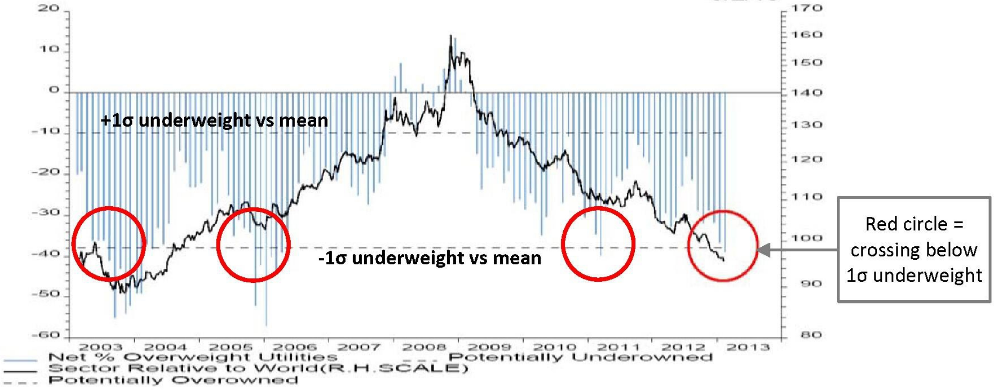
Global Sector Positioning



Substantially underweight

Source: Bank of America Merrill Lynch Global Fund Manager Survey, Feb 12, 2013

Net % Overweight Global Utilities



+1σ underweight vs mean

-1σ underweight vs mean

Red circle = crossing below 1σ underweight

Source: Bank of America Merrill Lynch Global Fund Manager Survey, Feb 12, 2013

The sector has been not only a substantial long-only underweight, but also a wholesale short for many macro/generalist hedge funds. However, it is very interesting to note that an inflection point appears to have occurred in the middle of 2012, with **hedge funds increasing their net exposure to the global utility sector** after a long period of reducing net. The long/short ratio of utility stocks held by hedge funds fell from 3.0x in Jan 08 to about 1.7x in Jan 12 (4 years), but has since risen by 60% to 2.7x, which is more than twice the increase for hedge funds' overall net exposure during the same period (source: Goldman Sachs).

Based on discussions with the Street, it appears that this short exposure has been expressed via ETFs, regional utility indices or large bellwether index utility proxies. Individual name crowdedness has continued to remain at a low level (e.g., utilities rarely show up Goldman Sachs Hedge Fund VIP list – ticker GSTHHVIP). Today, **utilities account for the lowest in gross assets held of the 10 global sectors**. (Source: Goldman Sachs Hedge Fund Trend Monitor analysis of 700 hedge funds with $1.3 trillion in gross assets.)

In addition, global QE programs have boosted demand for higher-beta stocks, which has contributed to the recent relative underperformance of and lack of interest in utilities. However (see below), the underperformance of US utilities has diminished with each successive QE round (QE1

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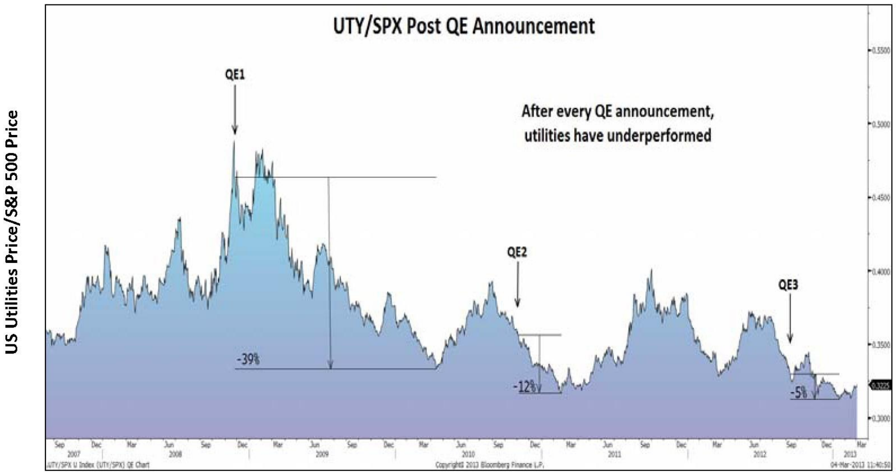
underperformance -39%, QE2 -12%, QE3 -5%), which signals exhaustion of selling pressure as the relative value of the S&P versus utilities has stretched further. Given widespread use of QE, a similar effect can be found in other regions.



Source: Bloomberg

3. Regional Structural Changes Driving Alpha Opportunity

Structural changes are occurring in all regions. Those in which Electron is currently investing or tracking closely are as follows:

- US Utilities

  Of the global utility markets, **we expect the US utilities market to face the strongest headwinds** and be the least-attractive market for alpha generation over the next 2 years. Since the financial crisis, **the US has been the best-performing region** for utilities of all the developed markets, outperforming European utilities by 40% over the last 4 years, and it is the region which is only slightly underweight by investors.

  The US is the most defensive of all regions because of the large weighting of regulated names. Since 2008, US utility earnings have been flat (versus a -45% decline in Europe), as consistent regulated earnings growth of 3-5% offset unregulated utility earnings declines resulting from lower power prices driven by falling natural gas prices. Notwithstanding flat earnings growth, **investors have re-rated the US utility sector's PE multiple** relative to the S&P as they sought more yield in a low-yielding QE environment. Today, US utilities are close to the sector's pre-crisis record valuation peak (trading at a 7% PE premium to the S&P 500) when investors were discounting higher earnings growth from tightening power markets (see below).

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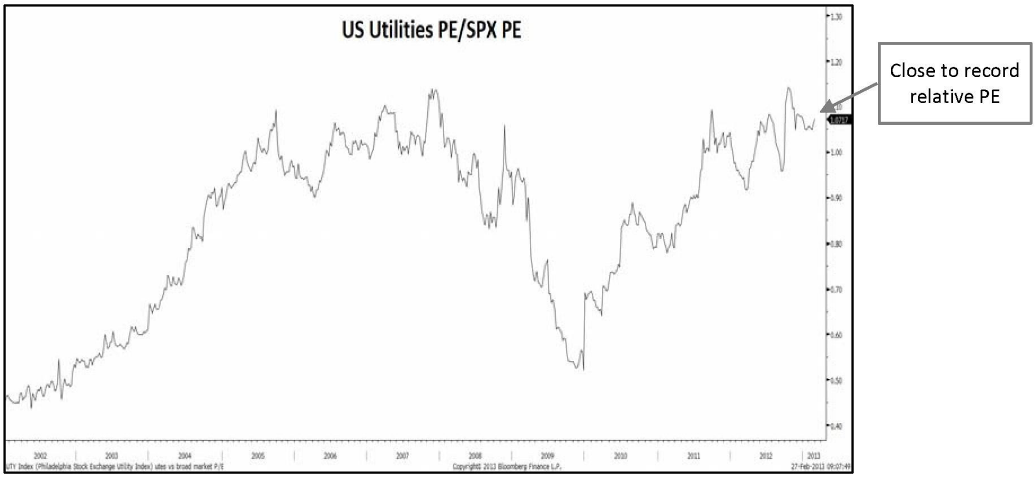

Source: Bloomberg

While we will continue to see solid growth from the regulated names, and a total return argument can still be made that justifies the current premium valuation of US utilities, we do see capex growth starting to level off. This is the opposite of what will happen in Europe and Asia, where we expect regulatory capex to increase. Moreover, we believe **US utility regulators will continue to pressure returns on equity (ROEs)** as interest rates remain low. We believe there is greater opportunity among companies with non-regulated power generation assets, as we expect firm natural gas and thus power prices to flow through to earnings. Note, for example, that every $1/mmbtu improvement in natural gas prices would increase Exelon's long-term earnings by more than 20%, whereas for pure generators such as NRG the leverage exceeds 30%.

Below is a partial list of structural changes driving long/short opportunities in the US:

Electron's structural changes: US

- **Coal retirements' impact on power markets**
- **Change in competitive generation market structure as a result of the shale gas boom**
- **Transmission spending to integrate renewables/improve reliability, and its impact on power prices**
- **Obama initiatives on climate change legislation, and the EPA threat**
- **Energy efficiency initiatives – utility uncoupling , demand growth**
- **Nuclear assets facing closure – impact on power markets**
- **Renewables' power markets distortions (impact on peak and off-peak power prices)**
- **Increased infrastructure spending to move shale gas from basins**
- **LNG export impact on gas and power markets**
- **Regulatory ROE changes with low rates, higher capex, declining load growth, commodity price changes**
- **Increased generator retail selling versus wholesale**
- **Capacity market in TX, CA**
- **State generation subsidy impacts on capacity markets**
- **M&A and asset divestitures' impact on power markets and utility risk profiles**
- **Oil-to-gas residential switching**
- **Electric vehicle demand impact**
- **Regional load growth changes – manufacturing renaissance, state taxes, etc.**

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- European Utilities

  We believe European utilities have the potential not only for the strongest outperformance but also for the greatest alpha generation. Since the financial crisis, European utility earnings have declined approximately -45% which is slightly less than European broader market earnings declines of -51% (Stoxx 600 or SXXP) and -58% (Stoxx 50 or SX5E). Prior to the crisis, European utilities used to trade at a 20% premium to the broader market. During the recovery, European utilities suffered a -43% derating and now trade at a 31% PE discount to the broader market. Most of this derating is explained by the European utilities' lack of participation in the European broad market PE multiple re-rating (SX5E +115%, SXXP +76%) since the recovery beginning in 2009. Moreover, approximately 40% of the sector is now trading below book value.

  Clearly, investors appear to believe that earnings have troughed for European companies broadly, but not for European utilities. Concerns about political intervention along with low power and carbon prices have prevented a re-rating of the sector. However, we are comfortable that we are **close to a bottom**, and that optionality is asymmetrically skewed to the upside for the European utilities, as **many generation assets are producing power at close to cash cost**.

  Relative to US utilities, European utilities have underperformed by -40% and the relative PE has de-rated by -11% since the crisis. The average European utility's relative dividend yield is now 95% higher than that of US peers before the crisis. Although some would argue that dividend cuts are coming (we agree broadly, and see several interesting short opportunities), we do not see the entire sector's dividends being cut by 50%, as stock prices imply. As such, the sector today has dividend support even though some dividend cuts will undoubtedly happen.

  In addition to dividends, potentially higher power prices from both higher European coal and carbon prices could also provide support. At present, the carbon market (EU ETS) in Europe is dysfunctional, with carbon trading at €5/tonne, well below the cost required to spur investment in low-carbon generating capacity. We expect the carbon market to be restructured (already being discussed), thus raising the price of carbon and increasing power prices. Moreover, with China's GDP growth reaccelerating and 70% of the resulting rise in electricity production generated from coal, we would anticipate a modest growth in coal consumption in the Asian seaborne market, thereby supporting South African and European coal prices. Given our view of rising US natural gas prices, we expect coal exports from the US to Europe to fall. These are all factors that should support European coal prices even before accounting for greater demand for coal that might come from Europe should growth return. Notwithstanding, short opportunities will remain in several European markets due to the influence of renewables.

  Moreover, if the European Central Bank were to lower its Main Refinancing Operations rate, currently 75 bps, and provide other monetary policy support, we would expect not only increased demand for electricity (which would increase coal consumption) but also a weaker Euro would increase the Euro price of coal (in Europe) and thus power prices. There are a number of factors at work here, and it is difficult to predict levels with any degree of accuracy, but even **small changes would have a significant impact** on the sector. For example, a combination of a +10% increase in coal prices, -10% decrease in the Euro/$ exchange rate, and a rise in the carbon credit price from €5 to €10/tonne would produce 25-50% earnings upside in many continental European utilities.

  Below is a partial list of structural changes driving long/short opportunities in Europe:

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Electron's structural changes: Europe

- **EU energy efficiency directive and load growth**
- **EU ETS (carbon market) changes**
- **Renewables build and power market distortions**
- **Mismatches between tariff rises and costs/capex**
- **Infrastructure spending impact on energy costs and power/gas competition**
- **UK capacity markets**
- **Large combustion plant directive (LCPD) (UK)**
- **Power market impact of nuclear phase outs (Germany) and new nuclear build (UK)**
- **Political interference on the continent (taxes, return formulas, tariffs)**
- **M&A, divestitures, privatizations' impact on power markets and changing utilities' risk profiles**
- **Bifurcation of sector valuation because of WACC changes**
- **European gas price delinkage from oil**
- **Ongoing renegotiation of Gazprom contracts**
- **European utility non-regulated investments moving offshore**
- **Erosion of the Italian power price premium**
- **New Italian water regulations**
- **Shale gas potential in Europe**
- **Implementation of Russian RAB-based regulation**
- **Electric vehicles**

- Asian Utilities

The Asian utility sector is a tale of two worlds. One enjoys a stable regulatory environment and solid power purchase agreements, as in Hong Kong and Thailand; the other is a victim of government intervention, as in Korea and China. The two worlds can coexist in the same country, for example in Malaysia where independent power producers enjoy solid power purchase agreements while utility Tenaga, which is a large employer and which faces the consumer directly, suffers from political meddling. Capex cycles and potential regulatory changes, respectively, tend to dominate performance of the two sides. For example, Korea Electric Power has outperformed sharply at times in the past on even small steps toward fuel cost passthrough implementation. In India's chaotic power markets, outperformance could arise from even small steps toward implementation of urgently-needed reform, e.g. any movement to improve access to fuel supply (notably coal) for independent power producers. The dichotomy between the two "worlds" of the Asian utility sector provides ample opportunities to generate alpha.

The vast population and developing nature of the region, and consequent issues of energy security and environmental sustainability, create **additional forces for structural change**. For example, as China increasingly promotes natural gas usage, we will see gradual pricing reform, more natural gas imports, greater natural gas vehicle adoption and accelerating shale gas development.

Below is a partial list of structural changes driving long/short opportunities in Asia-Pacific (ex-Japan):

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Electron's structural changes: Asia-Pacific ex-Japan

- **China power market policy changes to address record pollution levels**
- **Impact on China's power market of selective coal plant approvals**
- **Accelerating development of shale gas in China**
- **Urgently-needed power reform in India to address fuel, power tariff and grid issues**
- **Potential carbon trading and Renewable Portfolio Standards (RPS) in China**
- **Increasing promotion of natural gas usage and price reform in China**
- **Fuel cost passthrough implementation amid a potential power shortage in Korea**
- **Continued support for nuclear power by China – new-build approval delay impact**
- **Increased robustness of fuel cost passthrough regimes**
- **Indian import duties on equipment**
- **Increasing pressure on electricity tariffs in HK**
- **Rising Australian domestic gas prices on LNG export arbitrage**
- **Australian carbon market future**
- **Consolidation of the Australian supply market into an oligopoly**
- **Australian state regulatory evolution (e.g., electricity in Queensland)**

- Japanese Utilities

The **impact of the Fukushima incident on Japanese utilities** will last for years. Nuclear policy will continue to be reviewed – notably the decision whether to restart nuclear power plants – which will affect the utilities' long-term fuel mix and therefore cost base.

For example, Kansai Electric Power, which has the largest exposure to nuclear generation after Tokyo Electric, stopped paying dividends after the nuclear shutdown. Every 1% change in its nuclear fleet utilization rate will affect earning by almost 10% over a normalized level; nuclear policy decisions can thus create outcomes for share prices of +/- 50%.

The ripples from changing nuclear policy will have a long-lasting impact, both negative and positive, on companies involved in the nuclear value chain (e.g., reactor manufacturers such as Mitsubishi Heavy) and other power-related sectors such as gas and renewable energy. Relative to other regions, Japanese utilities will be the most affected by macro factors (e.g. the Yen, interest rates, fossil fuel prices, etc.).

Below is a partial list of structural changes driving long/short opportunities in Japan:

Electron's structural changes: Japan

- **Fukushima incident's impact on Japan's power-related sectors such as LNG and power equipment**
- **Derating of sector as a result of the government's response to Fukushima**
- **Restart of nuclear plants with Abe administration and prefecture support**
- **Fuel cost impact from Yen depreciation**
- **Movement to higher value-added renewable energy systems**

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- Latam Utilities

  Latin America will be a **trading market** for the next year or two. These markets, with the exception of Chile, are subject to significant government intervention, which follows long cycles; Brazil is early in the interventionist cycle (e.g., Brazilian President Dilma Rousseff's recent politicization of electricity tariffs), while other countries such as Argentina are closer to the end.

  Below is a partial list of structural changes driving long/short opportunities in Latin America:

  Electron's structural changes: Latin America

  - **Brazil's tariff intervention and consequent derating of sector**
  - **Argentina's increasingly urgent need for system investment and tariff increases**
  - **Shale gas development in Argentina and its impact on power prices and regional markets**

4. Global Structural Changes Driving Alpha Opportunity

In addition to region-specific structural changes, there are structural changes that have a global impact on the utility sector.

- Power Prices are Skewed to the Upside

  The cost of **natural gas and coal sets the marginal power price in many power markets** around the globe. The rapid rise in US shale production that began in 2007 caused domestic gas prices to decline much more rapidly than other fuels and put downward pressure on power prices both in the US and globally. For US gas-fired generator Calpine, lower fuel costs offset lower power prices and the company emerged a relative winner. Virtually all other US generators employ a mix of assets fired by costlier fuels and suffered a tremendous margin squeeze, with – in the most extreme example – coal-fired generator Dynegy declaring bankruptcy in 2012. We believe the downward trend in US natural gas prices has flattened for reasons noted below, and upward optionality remains, which will affect power prices not only in the US but also Europe and Asia given cross-border commodity linkages.

  In Europe, in an example of the regional, non-correlated character of the global utility sector, a quite **different dynamic** has taken shape, with coal-generated power margins remaining attractive relative to natural gas-fired generation margins. Coal prices in Europe have declined as a result of cheaper US and Colombian coal imports (because of US shale gas) and the knock-on effect of softening Asian coal prices. Carbon costs (i.e. EU ETS) embedded in power prices also have declined, from €16/tonne 2 years ago to €5/tonne today, largely as a result of the European recession. With European natural gas prices at 3x US prices (unlike in the US, natural gas prices in Europe are linked by convention to oil), European utilities have been minimizing natural gas generation and maximizing coal generation. So, unlike the situation in the US, coal generators such as Drax in the UK have enjoyed better margins on higher power output (see below) as gas plants sit underutilized.

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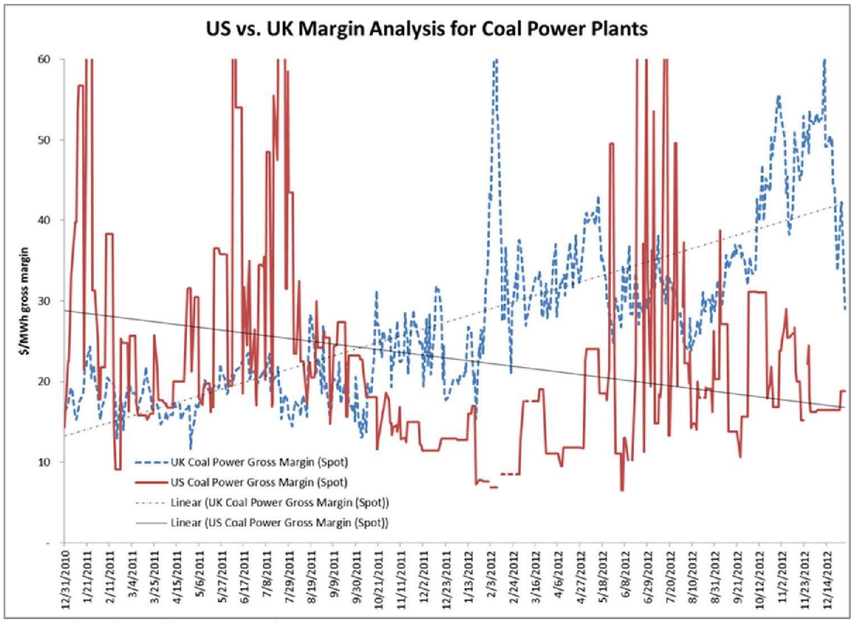

Source: Bloomberg, Electron Capital Partners

We believe a floor price exists for natural gas despite shale production. We fully acknowledge that the US has large reserves of shale gas awaiting development. However, the current spot price ($3.42/mmbtu) sits below the breakeven full-cycle cost of most US basins ($3.50-$4.00/mmbtu), which has led producers to focus on liquids-rich plays and de-emphasize dry-gas production. Accordingly, the gas rig count is at a decade low and the Energy Information Administration expects gas production to be flat through 2014. With the wide spread between oil and U.S. natural gas prices likely to continue, we expect the growth in liquids shale production to remain much higher than gas.

On the demand side, the power sector is the largest consumer (37%) of natural gas in the US. At prices below $5/mmbtu, coal switching begins, and at prices below $3/mmbtu, gas-fired power generating units become competitive against even the most efficient coal units. Importantly, the breakeven point for coal-to-gas switching will rise materially due to EPA mandates. By 2015, these standards move the breakeven point for the most efficient coal units from $3/mmbtu to approximately $4/mmbtu, close to where current forward prices sit.

Large potential structural changes in demand create upside optionality. There has been much media focus on the growth of shale gas production, so much so that we believe potential demand drivers are underappreciated. For example, currently-planned US coal plant retirements, if repowered with gas, would support an additional 6 billion cubic feet per day (bcf/d) of gas demand, adding nearly 10% to total US demand. In addition, we see the potential for LNG exports to exceed another 6 bcf/d (27 bcf/d of project capacity awaits US Department of Energy approval). Cheap gas is also spurring an industrial resurgence, with new petrochemical plants being proposed in the Gulf and traditional coal users such as steel mills contemplating refiring their facilities with gas instead of metallurgical coal. Longer term, LNG as a vehicle fuel substitute for long haul trucks and CNG for lighter vehicles could also add materially to gas demand. Given the number of possible structural demand changes and the enormous potential from each, we believe the optionality for natural gas prices is clearly to the upside.

We believe the recent trend of softer US natural gas prices leading to a deflationary impact on global utility sector earnings is, then, largely played out. Longer-term, we see many positive demand

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fundamentals that are supportive of higher natural gas prices; while we don't expect a return to the commodity boom times of 2003-2007, a turn in trend will be very supportive of higher share prices.

- Capex (ex-US) is Rebounding Post-Recession

  Capital spending precedes earnings, and **utility capex (ex-US) is rebounding after a recession-driven slowdown**. In particular, transmission spending is accelerating in Europe (Germany, Spain, France) and Asia while remaining firm in the US. Transmission capex not only enhances system reliability but also system efficiency, by enabling the delivery of the most efficient generation to meet demand. Many transmission grids face bottlenecks because of the inclusion of intermittent renewable generation in areas with ample wind and solar resources but located far from customers. Companies such as Northeast Utilities (US), National Grid (UK) and Elia (Belgium/Germany) are prime beneficiaries of this transmission capital spending, along with equipment providers such as ABB (Switzerland).

  In addition, **many global utilities will be viewed as back-door beneficiaries of the shale gas boom globally** given the substantial amount of capex required to build new or upgrade existing infra-structure. US utilities are building much of the infrastructure to export gas out of the shale basins (Dominion, NiSource) and are building LNG liquefaction facilities (Dominion, Sempra) that are at the front of the queue for US Department of Energy approval. Several European utilities, such as GDF Suez (Belgium/France) and Gas Natural (Spain), and Asian utilities such as Kunlun Energy and ENN Energy (China; note that China has 2x the shale gas reserves of the US) are exposed to LNG infrastructure spending.

  Finally, because of emerging markets' growth rates and a higher intensity of energy use, **emerging market utilities** will benefit from infrastructure spending across the entire utility value chain**.**

5. Substantial Alpha Opportunities Follow Periods of Underperformance

The global utility sector has experienced record underperformance and often this precedes substantial alpha opportunities.

- Record Duration and Depth of Underperformance

  We have analyzed the price performance of the global utility sector since 1995, when MSCI introduced its Global Sectors. Although the period includes only 18 years of data, this is the relevant time frame as it effectively covers the entire period of industry deregulation (see Appendix 2, page 25).

  As can be seen below, the current period of global utility underperformance is the deepest (-67%) and longest (4 years) of the modern utility era. Even with the strong rally in equity markets since the financial crisis, the global utility sector is still down -11% on an absolute basis. It has not only been the worst-performing MSCI global sector but has also underperformed the second-worst global sector by -23%.

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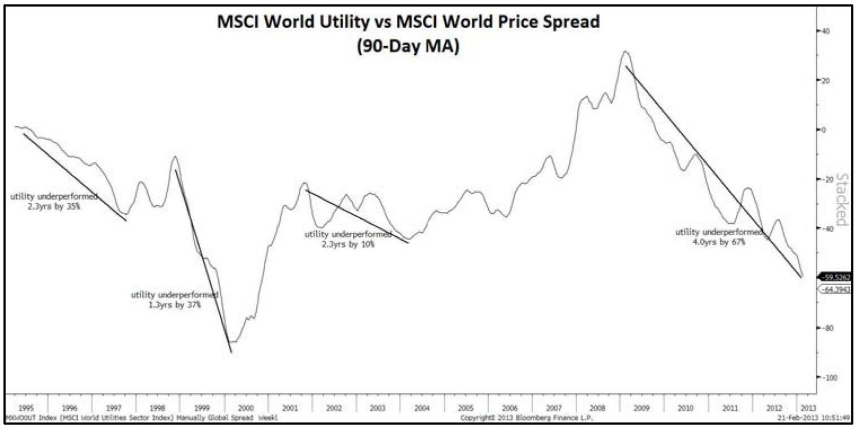

Source: Bloomberg

	Price		
MSCI Global Sectors	**1/1/2009**	**12/31/2012**	**Performance**
Consumer Discretionary	68.5	132.4	93%
Information Technology	54.2	96.9	79%
Materials	146.1	237.2	62%
Industrial	101.4	155.8	54%
Consumer Staples	104.7	160.5	53%
Health Care	89.1	128.4	44%
Energy	181.9	238.9	31%
Financials	63.0	82.0	30%
Telecom	51.0	56.9	12%
Utilities	**113.4**	**100.9**	**-11%**

Source: Bloomberg

- Reasons for Underperformance

  Much of this recent underperformance can be explained by investors' textbook preference, coming out of recession, to add high-beta stocks and shed low-growth utilities. This was exacerbated by:
    - soft power demand growth (particularly in Europe);
    - generation overcapacity;
    - delays in capital spending;
    - lower commodity prices (particularly as a result of US shale gas production);
    - central banks' quantitative easing;
    - political interference (notably in Europe);
    - high debt loads;
    - the Fukushima nuclear disaster in Japan; and
    - concerns about interest rate rises from today's very low levels.

  It is hard to imagine a more perfect storm for the global utility sector than that which has played out over the past 4 years.

- Potential Exists for Sharp Outperformance

  Globally or regionally, **it is not unusual to find long and/or sharp periods of utility underperformance** (as with the current record period). During such periods, when combined with wholesale shorts and market underweighting, the sector becomes **poised for extended outperformance rallies**. This results from fundamental investors (both long/short and long-only) rotating into the sector en masse, bidding up the best value and growth utilities and underweighting or shorting utilities with poor business

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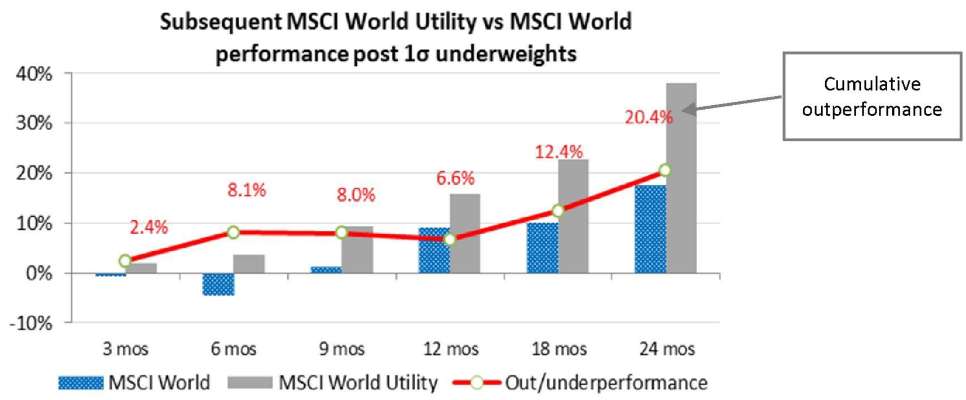
models/prospects. This can be triggered by improving sector fundamentals, better data points, or conversely by events that instead lower investors' perception of economic growth prospects (e.g., policy errors, rising European sovereign yields, higher commodity prices, etc.).

As noted above (page 5), each time the sector's underweighting reaches 1 standard deviation below the mean, over the next 24 months global utilities rise by 38% on an absolute basis and outperform the global broad market by 20%, on average (see graph below).



Source: Bank of America Merrill Lynch, Bloomberg

When these outperformance rallies occur, the potential **massive alpha opportunity** can be substantially greater than the return from a fund's net position.

As examples, we highlight the lessons from the dotcom period (second only to today's record underperformance) and lessons from Japan (given the deleveraging environment of today).

- Post-Dotcom Rallies

  The last time we saw underperformance anywhere close to today's magnitude was during the 3-year run-up to the dotcom bust (see graph below) as investors grabbed for growth in the "new economy". During the run-up (Jan 97-Jan 00), tech and telecom were the best-performing sectors, +322% and +162%, respectively. The global utilities sector was the second-worst-performing global sector, +12% and in line with the +9% worst-performing materials sector.

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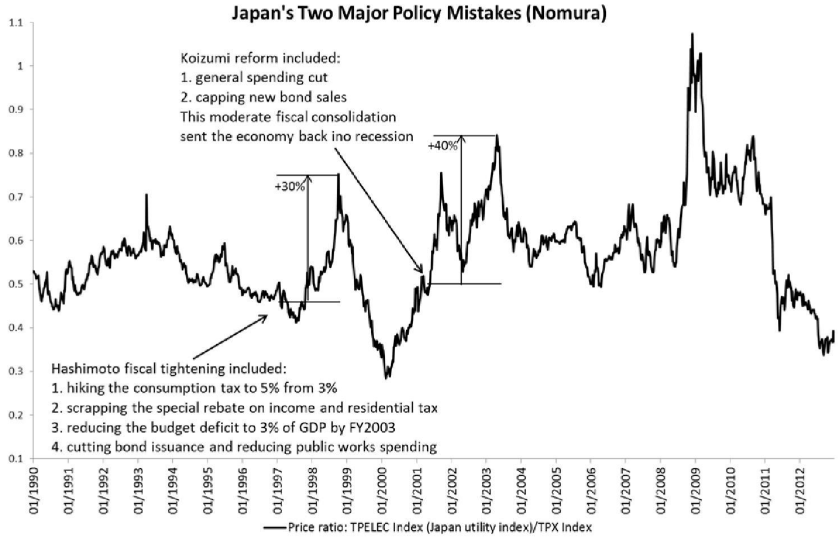
the broader market. Following the policy errors, Japanese utilities staged exceptionally strong outperformance rallies lasting over 1.5 years, on average, and outperforming the Topix by 30-40% (graph below).



Source: Nomura Research Institute, Bloomberg

During the Jan 97–Nov 98 policy error period, fundamental investors bid up the better prospects (Tokyo Electric Power and Osaka Gas each rose 34%) while the Topix declined by -19. During this same period, some Japanese utilities also posted sharp absolute declines, such as Hokkaido Gas -49%, Saibu Gas -30% and Okinawa Electric -27%. During the May 01-May 03 policy error period, Okinawa Electric and Hokkaido Gas rallied +40% and +23%, respectively, while the Topix declined -44% and Tokyo Electric Power and Osaka Gas declined -13% and -7%, respectively.

The Japanese utility experience is very interesting as several **economists question whether the US is currently committing similar policy errors** while deleveraging is still occurring in the private sector (e.g. the US just increased income and payroll taxes and is implementing austerity measures). The Japanese experience demonstrates the potential for strong outperformance rallies during periods of deleveraging, demonstrating the alpha opportunity arising from an influx of fundamental investors into the sector after periods of limited interest.

- Potential for Yield Catch-up

Unlike other income-oriented investments such as Treasuries, German bunds, UK gilts, investment-grade bonds, high-yield bonds, emerging market bonds and MLPs, all of which have rallied strongly – some believe as the result of a yield bubble – **the global utility sector has been left behind**; yet certain parts offer a compelling investment yield opportunity today. If some fixed income cross-over investors become more concerned about inflation (because of economic growth), yet continue to be squeezed by the QE programs of the Fed, BOE, BOJ, etc., then they could begin shifting into global utilities. This seems logical, as such **investors would look for the closest bond proxies** in the equity market, the utility sector, rather than bypass utilities for high-beta broad market stocks. **Given the enormous amounts of capital controlled by fixed income cross-over investors, even a small reweighting could have a significant effect in bidding utility stock prices up and yields down**.

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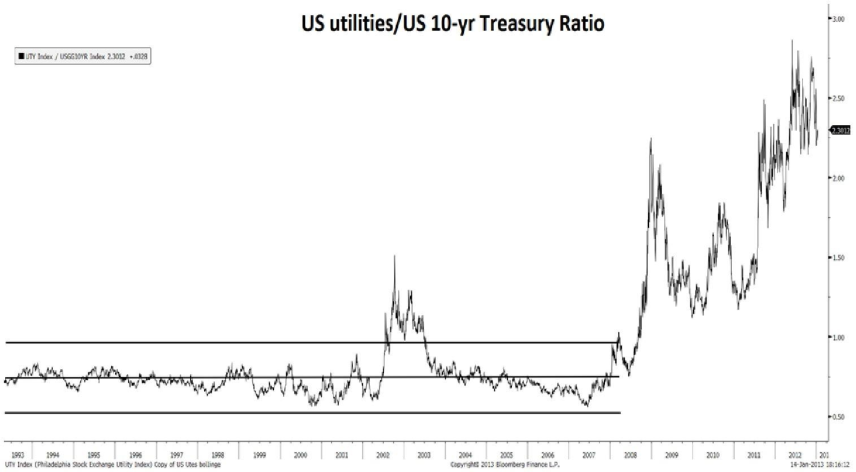
6. Interest Rate Risk – A Common Misperception

We find a common misperception among investors to be the degree of interest rate risk in the global utility sector, as **interest rate sensitivity has declined steadily** since the modern utility industry came into being in the early 1990s.

There is a relatively higher degree of interest rate risk in the defensive, fully-regulated utilities given their bond-like returns and the capital-intensive nature of the industry, which demands heavy use of debt financing. Such defensive fully-regulated utilities can be found in all regions, however the **highest concentration is found in the US**. European, Asian and Latam utilities are more levered to economic growth and therefore tend to be no more interest rate-sensitive than broad market equities.

Even the performance of the more interest rate-sensitive US utilities is not fully determined by interest rates. For example, during the market rally from fall 2002 to summer 2007, the US utility sector generated a non-beta-adjusted annualized total return 5.2% higher (2.8% from better price appreciation and 2.4% from dividend reinvestment) than the S&P 500, while the 10-year Treasury yield rose from 3.6% to 4.9% (+130 bps) over this period. Valuation re-rating and earnings growth from generators, as economic growth tightened power markets and raised commodity prices, outweighed the negative impact of rising interest rates.

We would note furthermore that yield relationships have moved to unprecedented extremes such that, for example, the **dividend yield for US regulated utilities versus the 10-year Treasury yield currently sits at 7 standard deviations above the mean** from the historical pre-2008 environment (see graph below). **An even more dramatic relationship exists for the European utilities**. This suggests that policy rates are at such levels that there is substantial cushion against rising rates.


US utilities/US 10-yr Treasury Ratio

Source: Bloomberg

Finally, **we track interest rate risk in the Electron risk model for all positions**. We are not looking to make macro calls, and the portfolio's net interest rate risk is kept within acceptable limits as we select stocks in the global utility sector. This process has worked well for us as over 7 years we have posted strong returns and alpha generation in both rising and falling interest rate environments. As a result, many investors are pleasantly surprised to learn that despite perceptions of the global utility sector's interest rate sensitivity, **Electron's return correlation to interest rates is slightly lower than the HFRI Equity Hedge Index's return correlation to interest rates.**

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Appendix 1: The Team and Our Process

- Electron Focus

  Electron's universe of utility and infrastructure stocks is deep, comprising 375 companies with a market cap of $2.8 trillion. Stocks covered include the electric, gas, water and waste utilities in addition to infrastructure companies (defined as those levered to utilities or utility-like). Our approach is truly global as 40-60% of the portfolio's historical gross has been allocated outside the US.

- Electron Team

  Electron's cohesive, long-standing team consists of 8 members, including 5 investment professionals who have worked (with Jos Shaver as Portfolio Manager) at SAC Capital and the original Electron Capital for an average of 6 years. In addition, 4 of the 5 investment professionals have lived outside the US, a distinct competitive advantage given our global approach. Each investment professional brings his/her own specific expertise and diligent research to our process, working collaboratively across regions to conduct deep-dive research on the most compelling opportunities in the global utility sector.

  The other members of Electron complement the skills and experience of the investment team. Electron's experienced operations/investor relations professionals are former Intrepid Capital employees who worked with the Electron team during the first iteration of Electron (2005–2008) when the firm had a services agreement with Intrepid Capital.

  Finally, a Senior Advisory Board consisting of former C-level utility executives from around the globe has been with the team since the launch of the original Electron Capital in 2005, and all have rejoined for Electron's re-launch.

  As Portfolio Manager, Jos Shaver has covered the global utility and infrastructure sectors for the past 21 years, and his sector perspective benefits from his having lived 10 years abroad (5 years in Asia covering the Asian utilities and 5 years in Europe covering European utilities) and 11 years in the US. In addition, as Managing Partner, Jos controls all major decisions at Electron.

- Track Record (7 years)

  Electron's 7-year track record (3 years audited from the original Electron and 4 years from SAC Capital) has annualized 10.3% since inception and has been characterized by strong alpha generation on both the long and short side (80% of returns, based on Jensen's alpha calculation). Electron generated this 7-year track record during an exceptionally challenging period for global utilities – the MSCI World Utility Index has been the worst-performing MSCI Global Sector ex-financials over the track record period, down -0.2%. Notwithstanding, Electron's track record has bested the MSCI World Utility, S&P 500 and HFRI indices by 91%, 67% and 61%, respectively.

- Process

  First, given Electron's global approach to utility research**, we tend to have a clear competitive advantage with respect to early recognition of cross-border structural change** (e.g., how a change in Asian seaborne coal market might affect off-peak power prices and thus earnings for a Midwest US utility). Moreover, our global research approach allows us to gain perspective on structural change outcomes given our knowledge of global precedents and the likely reaction from various interested parties (e.g., governments, regulators, managements, customers, consumer groups, rating agencies, shareholders, debt holders, et al.) We analyze other global precedents, develop a thesis and then conduct deep-dive research to gain conviction. Once we have developed a structural change thesis, we proceed to a full bottoms-up analysis

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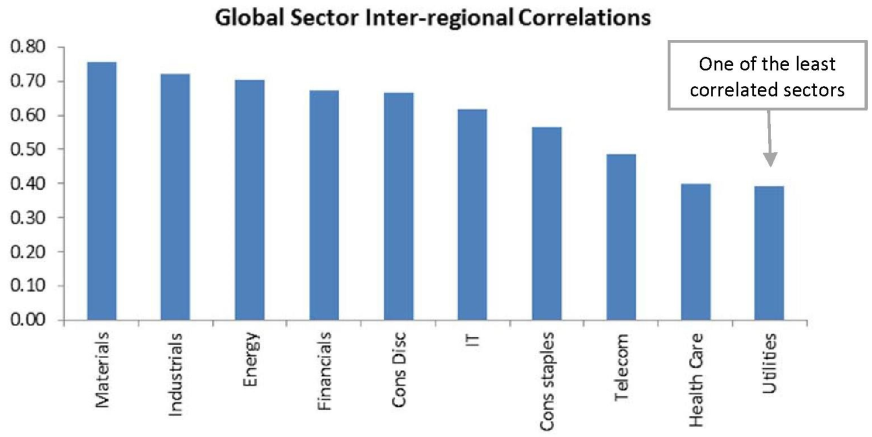
of the earnings impact for the relevant companies, and assess what might be priced in by thoroughly reviewing the Street's numbers and commentary. It should also be noted that the same structural event often affects not one but several companies, and the implementation of these structural changes are typically not one-day events. As such, depending on the situation, we may have the opportunity to capitalize on the same structural change event several times as it develops.

Our research process is our primary idea generator. We travel extensively and, collectively, the 5 investment professionals will have between 600 and close to 1,000 meetings a year as we speak with companies, regulators, consultants, sell-side analysts and governments.

- Why We Take a Global Approach - The "Greatest Gift"

Electron takes a global approach (historically, 40-60% of gross allocated outside the US) to the utility sector: i) to spot structural change and resultant inefficiencies early, ii) to provide a wider canvas to allocate capital around the globe to the most attractive (from a risk/reward point of view) alpha opportunities and, most importantly, iii) to enable the Electron Global Funds to take advantage of the **global sector's very low inter-regional correlation** (i.e., correlation of regions within the global sector; lowest of all MSCI global sectors – see below).



Source: MSCI, 7 years' weekly trailing correlation

We call this very low regional correlation the global utility sector's **greatest gift** to long/short investors as **it provides a greater return per unit of risk** if one has the ability to dynamically allocate capital to and generate alpha in all regions. There are few long/short global utility funds today given the global utility experience required to capture the greatest gift, as different countries have different utility market designs and structures.

The Electron process starts with a focus on structural change and we embrace the myriad of utility markets' differences around the globe because this approach leads to the most attractive alpha opportunities and the benefits of the "greatest gift". **We allocate capital dynamically** to the most attractive alpha opportunities in the global utility industry. As a result, the Electron Global Funds is only one fund, yet the "greatest gift" provides **the diversification benefit of 4 relatively uncorrelated regions and concentration in the globe's most attractive alpha opportunities**.

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- Capitalizing on Structural Change Timing

  Although some of the structural changes discussed earlier happen in days or weeks, e.g. fuel cost passthrough adjustments, others will take years to implement, for example, new capacity payment structures. Because of the sector's high earnings visibility, however, we do not have to wait until a particular structural change occurs for a thesis to play out. Utilities often have earnings visibility 2-3 years out (including Street estimates) which is in contrast to other sectors (e.g. tech) which often times do not have 2-3 quarters of visibility. As such, utility stock prices (and the Street's estimates) will begin to discount even some of the longer dated structural changes as clarity surfaces in the early stages. Therefore, there is a distinct competitive advantage for those who have an early understanding of such structural changes and the resulting earnings impact on affected utilities. We therefore focus our efforts on discerning the structural change opportunity early in an effort to come up with a view before it becomes obvious to the broader market.

  Moreover, there are often several opportunities over an extended time period to trade the same structural change as numerous stakeholders (e.g. government, regulator, company, customers, et al.) involved in the process distort market perceptions of the final outcome.

  Although **structural changes are the "home run" opportunities**, Electron returns are not limited to such changes, as we also consistently play for **"singles and doubles" in the global utility sector** with earning releases, regulatory reviews, dividend increases and decreases, relative value, regulatory arbitrage, etc.

  As evidence of Electron's ability to successfully trade both shorter- and longer-term structural changes, please note our sweet spot for generating returns over the 7-year track record has tended to be 45-90 days.

- Portfolio Construction

  Typically, the portfolio has 70-100 positions, but concentration is very important to generating returns. Historically, the top 10 longs represent 40-50% of the Fund's value, and top 10 shorts represent 30-40% of the fund's value. Typically we will have a 10% position in the portfolio; this is invariably a liquid, big-cap utility name with limited downside and a good degree of upside which is expected to be favorably affected by a key, underappreciated structural change.

  The **stronger the conviction (from a risk/reward point of view) in the alpha opportunity, the higher the gross we run**. This flexibility in portfolio construction (which we successfully proved over 3 years during the first iteration of Electron) provides a distinct advantage given the utility sector's many low-beta, low-volatility stocks. During the original Electron Capital period, gross ranged from 150% to 215% and a median of 185% over the period. We see maintaining a similar operating range for gross for the re-launch for Electron.

  Regarding nets, **we will always have a properly hedged product** as there are always opportunities on the short side to generate alpha. Over our 7-year track record period, the net averaged 22% net long. During the first 3 years of Electron, our net averaged 30% long. Given our bearish view on utilities over the last 4 years, the net averaged 17% net long.

- Risk Model and Risk Management

  We view utilities as distinct bundles of risk. Just as we are staunch supporters of sum-of-the-parts (SOTP) valuation, we are also believers in SOTP risk monitoring. As such, our **risk model developed over the last**

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8 years tracks approximately 60 industry, commodity, and financial risk metrics and is a focus for the Electron team. For example, consider oil price risk; although there may be no direct oil exposure in the portfolio, there is indirect oil exposure if we were to be short Drax, a coal-fired generator that sells power into the UK power market. In the UK, natural gas sets the marginal price of power, and in Europe, by convention, natural gas is linked to the oil price; as such, a short position in Drax represents an effective short position in oil. We track this risk along with numerous other factors that affect utilities, with the purpose of minimizing risks for which we have no competitive advantage that would justify taking on the exposure. We describe the risk model in more detail in the marketing book. In addition, we make the Electron risk model available for all prospective investors' due diligence.

Each position in the risk model contains a thesis write-up (to avoid thesis creep); upside, downside and relative targets (for valuation discipline); and a time frame (to avoid collecting stocks). In addition to tracking numerous industry, financial and macro risks, we also track alpha generation for all of our regions, sectors, subsectors and sub-subsectors, which provides the added benefit of a granular window on market flows. Finally, we incorporate **an exponential function** into the risk model **that provides an early alert** and focuses our attention when something is not working. For example, we might be short XYZ utility with 30% downside potential over 3 months, and put in a 15% loss limit. If in the first week XYZ runs up 5%, it will trigger a "FAST" move alert in the risk model. If we cannot explain why the position is moving against us, we will cover (i.e., when in doubt, get out). As mentioned, this is not a crowded space (rarely do utility names appear on the Goldman Sachs Hedge Fund VIP list) and many names are low-beta, low-volatility stocks. However, often when money is lost on the short side, it is the result of small daily losses that would not be noticeable on any given day, but over even short periods of time can add up to sizeable losses.

- Shorting Global Utilities

  - Experience with Dividends and Investor Behavior

    During the underperformance of the global utility industry over the last 4 years, Electron generated very strong alpha on the short side. We spend almost twice as much time on the short side as we do the long side; this is driven not only by the need for more short positions (given the asymmetry of risk) but also because of **the effect of utility dividends on investor behavior**. For example, we might be short a large cap utility with a 4% dividend yield that we believe to be a structural loser. The stock might decline 25%, which would push the dividend yield up to 5.5%. Even though our valuation models might tell us there is still another 10-15% valuation downside, we will tend to cover (unless we believe the dividend is materially at risk), as the dividend yield will begin to provide support for the stock. The precise level of the dividend yield at which we would cover is as much an art as a science, as it is based on our experience in a variety of situations and our views on investor behavior (particularly income funds) gained over many years of covering the sector. As such, you will find us trading around our short positions more frequently than our long positions.

  - Key to Electron's Process to Identify Dividend Change Candidates

    We also have developed a certain expertise in being early and correctly calling dividend changes – an event that can have a dramatic impact on the performance of utilities given the make-up of the investor base. In our long experience, utility CEO/CFOs will strongly defend the company's dividend (often borrowing or selling assets to fund it). As such, when they do finally cut the dividend, or talk about the possibility, they often surprise the market.

    It pays to be diligent in assessing the potential for a dividend cut, and to be early, since once CEO/CFOs accept that their business model is deteriorating, they will quickly take action, especially if their companies have less flexibility (particularly with respect to cutting capex and opex). Large-cap utility managements desire strong credit ratings and are reluctant to risk an investment grade rating.

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They are in a capital-intensive business and need to preserve deep, low-cost access to both the equity and debt capital markets. Moreover, collateral requirements for forward power price hedging typically will spike if a utility loses its investment grade rating, which can spur concern about liquidity.

Building conviction around a dividend cut thesis requires more than screening. **Our process focuses on researching capex flexibility, cost-cutting potential and asset divestiture potential to determine the flexibility** a company has under various scenarios. Our research process breaks capex into 3 buckets: i) committed capex (e.g. required by the regulator), ii) nondiscretionary capex (e.g. major plant overhauls – CEOs tend to avoid delays so as not to jeopardize billion dollar-plus assets), and iii) discretionary capex (CEOs can delay but may jeopardize future growth).

Regarding opex, we look for cost-cutting capability, which we estimate by breaking apart the opex line or by global benchmarking. Finally, we estimate the potential impact from possible asset divestitures and the resulting impact on earnings and leverage. Once we have completed the research work on capex, opex and potential divestitures, we model various sensitivities from structural changes or other key drivers that might cause a deterioration or improvement in a utility company's business model against forward-looking credit rating agency (S&P, Moody's, etc.) ratios.

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Appendix 2: Global Utility Sector Background

- History

To gain a deeper appreciation of why the global utility sector is attractive for long/short investing, it is helpful to briefly survey the history of the sector and describe the utility value chain's components.

The utility industry as we know it began in 1882 when Thomas Edison built the world's first generating station on Pearl Street in downtown Manhattan. In the early decades the industry evolved along multiple lines but eventually settled into an integrated, fully-regulated model, deemed appropriate as utilities were considered to have monopoly power. During the era of full regulation, **utility stocks were often characterized as low-risk "widow and orphan" stocks** in the US, and large parts of the global utility industry remained government-owned. During these early days, long/short investing could not have existed at scale, as the ability to find and generate short alpha would have been difficult given the sector's government ownership and bond-like nature of returns.

In the 1980s, Lord David Howell (formerly UK Secretary of State for Energy in the Thatcher government) advocated having then-fully regulated power plants compete to sell their production into a competitive power market (a "power pool") where the price of electricity would be set at the intersection of supply (power plants) and demand (industrial users and electricity supply companies selling to households). This led to the **world's first competitive power pools being rolled out in the UK in the early 1990s**. While based in Asia, Jos Shaver led UBS' Asian utility industry group and had the privilege of working with Lord Howell when UBS acted as advisor to the State Power Corporation of China on the restructuring of that country's national power industry.

Competitive power pools have since sprung up all over the world, and regulators have pulled apart previously fully-integrated utilities in the name of efficiency and maximizing competition. In addition, governments around the world have begun to privatize their state utility industries and organize bespoke competitive market structures that best meet their needs. These changes have resulted in a hybrid modern industry which continues to evolve.

The deregulatory impulse has brought tremendous benefits to national economies, driving down costs and improving efficiency and system reliability, but has also produced unintended consequences, e.g., the high-profile bankruptcies of Enron, British Energy, Dynegy, NRG, PG&E and others. As such, although one can still find low-beta, low-volatility defensive stocks, **the global utility sector has not been for "widow and orphan" investors for quite some time due to structural changes** in an evolving industry that continue to alter the investment landscape.

It is important to note that **the modern utility industry is still in its infancy**, having begun in the early 1990s, and its continued evolution – structural change – will provide ample long/short opportunities for the foreseeable future. **Structural change catalysts are driven by**: i) a utility's various stakeholders, including governments, managements, consumers, et al. which seek to mold the utility to their needs and objectives, or ii) variables outside of stakeholder control such as commodity prices and new technologies. A **specialist approach** to the global utility sector is essential as each country's market structure (and often that of regions within countries) can be very different as a result of the varying levels of competition, market concentration, geographic constraints, infrastructure bottlenecks, regulatory constructs, fuel supply availability and so on.

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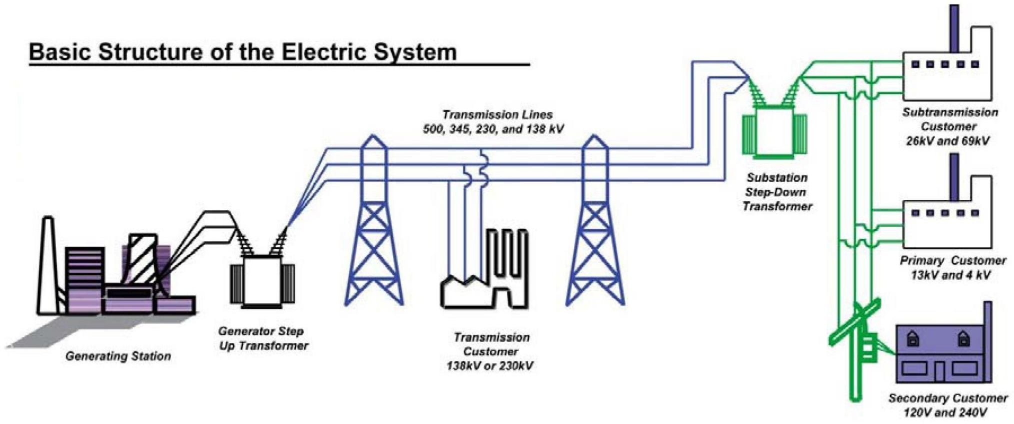
- Utility Value Chain

The electricity value chain for a modern day fully integrated utility consists of **Generation + Transmission + Distribution + Customers** (see diagram below). Each segment of the value chain is a different business, with distinct risks and economic drivers. Competition has surfaced in each part of the value chain other than transmission and distribution (which are fully-regulated assets as they are deemed to be natural monopolies). Still, regulators have learned to bring indirect competition even to monopoly-regulated businesses by encouraging returns based on efficiency improvements or benchmarking to comparable companies.


Basic Structure of the Electric System
Transmission Lines
500, 345, 230, and 138 kV
Substation
Step-Down
Transformer
Subtransmission
Customer
26kV and 69kV
Primary Customer
13kV and 4 kV
Generating Station
Generator Step
Up Transformer
Transmission
Customer
138kV or 230kV
Secondary Customer
120V and 240V

Source: US Department of Energy

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Disclaimer

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It’s an absurdly vast house, among the largest in Manhattan, but the dining room is windowless, creating a hermetic or stop-time sense, broken only by the household staff ferrying in time-of-day-appropriate foods and beverages.

The real world seems terribly far away, but with paparazzi often posted near by, it’s dangerously close too. Once I arrived for a visit and found several police cars blocking the street and thought the worst—they’d come for him again. But it was a security detail for a controversial head of state who had come for tea.

We met several years before he became arguably the world’s most notorious sex offender. In 2002, his plane, a meticulously appointed 737, ferried a group of people to the TED conference in Monterey. He was the mysterious and peculiarly gracious host arriving after everyone had boarded: tanned, relaxed, attentive, soliciting every guest’s story and views, and accompanied by three young women not his daughters, witty, poised, helpful, and beautiful—out of a men’s magazine fantasy of the luxe life.

One more thing about this trip suggesting something of his unique view of the public world and what you got to see when you are near him. Google founders, Larry Page and Sergey Brin, with their company rising into the stratosphere, came out to see his plane on the Monterey tarmac and, with a few other Googlers, literally ran whooping from one end of the plane to the other. Then, sitting in the plane’s plush living room, they described, in what I could not be sure was a put-on or entrepreneurial brainstorm, a brand extension in which they would market a line of Google bras with the Os as convenient cups. In fact, the name Google, they said, was invented out of the belief that men would focus on a word with two Os in it.

Since that trip, and through his travails, I have often been invited to his house to participate in the conversations that take place there.

In sweatshirt, draw-string pants, palm beach slippers, and half glasses, Jeffrey Epstein—*that* Epstein, most recently embroiled in charges involved under age girls and Alan Dershowitz and Prince Andrew—spends most of his day at his dining room table in the in front of a laptop and beside a row of reading glasses (there are a lot of them in case, apparently, he misplaces a pair, but being quite meticulous he never does) conducting what must surely be the world's most extraordinary colloquial.

These meetings, and this lifestyle, have somehow stayed private or secret—or apart—not out of any formal or stated restrictions, but because, in some sense, it would be very hard to explain just what you're doing there with a brazen sex offender in a guffaw-inducing home flaunting all moderation.

And yet, defying disgrace, and tolerating his tone deafness—or mocking attitude toward the zeitgeist—so many come. Gladly. Willingly. Feeling that his invitation is quite an extraordinary privilege.

Among his frequent guests is Bill Gates, for whom Epstein has become a key advisor, proposing a way to leverage the resources of the Bill and Melinda Gates Foundation to accommodate many other fortunes, so that, Epstein explains, “you might join 50 or 60 billionaires on one giving project.”

As part of a Gates-encouraged effort to get “out in front” of the notice that might be expected to greet the Gates association with him, Epstein agreed to these on-the-record conversations with me.

His subject, on a morning in late fall, sitting at the dining room table—its faux-baronial quality disturbed by an ever-present white board—is “hyper wealth.” His subject is always wealth—how capital should react to the given global political, economic, and cultural moment.

His stock in trade is not precisely the making of money, but the issues that arise when money, at a heretofore unimaginable rate, makes itself, altering many basic economic, social, and personal calculations. He recounts a dinner he had two nights before. The scene is, like much of what he does, a conspiracy theorist’s fantasy—the six men at this dinner, all technology entrepreneurs, representing, together, several hundred billion dollars and now trying to figure out how to use it to shape the world to their liking.

“In the past, only governments had this kind of money, money of a reality altering scale,” says Epstein in a chipper and smoothed-out Brooklynese. “In fact, it used to be that the rich, reaching a certain point of philanthropy, merely hoped to help make the world a better place, now they want to change the world. Rockefeller and Carnegie were, as examples of social-engineering philanthropy, unique. They alone had such resources and will. Now you have legions of people who have to give away vastly larger fortunes than Rockefeller or Carnegie had at their disposal, or might even have imagined.

“Except that it’s actually hard to give away this kind of wealth, without unintended consequences that can cause more problems than you’re solving.”

Epstein’s long-time business thesis is that the rich know very little about money. They may know about their own businesses, but the great sums that are the result are ultimately an afterthought and demand an entirely different sort of intellectual discipline. The Forbes 400, says Epstein, not immune to an amount of wonder, increased their wealth by $500 billion last year, meaning, in effect, that on average every Forbes-list billionaire makes more than another billion every year. And, points out the 62-year-old Epstein, they will almost all be dead in 40 years, most well before that, meaning $4.2 trillion, compounding everyday, will have to be given away. “So, to understand the future, what you have to begin to do is follow the money, not in Watergate-like terms backwards, as in who has gotten it, but forwards to where it will go and who will get it.”

Epstein can find himself echoing aspects of Thomas Piketty on the inequities of the accumulation of wealth ("the divide is between people with assets, which appreciate, and people without assets, who fail to advance—that is, of course, the miracle of compounded interest"), except for the fact that Epstein, knowing the rich, understands a point that Piketty doesn't: "Nobody, *nobody*, wants to give it all to their children. Everybody now has the modern appreciation that one of the curses of great wealth is that it can make your kids weird and fucked up."

Epstein's position in this private allotment of a decent fraction of the U.S. Gross Domestic Product is not as a philanthropist but as a sort of adviser or guru or brain—a rich whisperer—making him, in addition to rich himself, arguably among the most influential people you've only heard of for reasons that have nothing to do with his influence.

Epstein sometimes seems to have an out-of-body attitude toward his own fate and bad press—that's something that occurs in a less interesting parallel world. Not long ago, when I met him for lunch in New York, he noted that he hadn't been out to lunch in a restaurant in ten years. It was a not particularly pleasant experience for him and we were done in 30 minutes.

On the other hand, Epstein's life sometimes seems part of a purposeful challenge: not just look at me, but do you even believe what you see? But, perhaps, he is just oblivious to what others are thinking: a willful and in a sense fatal tone deafness.

Press accounts recycle the mysterious billionaire mythology—a man of vast and unsourced riches living in a parallel universe of absolute entitlement—with brief glimpses of him stepping out of the house (the same photos endlessly republished), and the assumption of depravity inside.

In fact, the life in the house, without wife or children or conventional domestic demeanor, rather conforms to the scripted fantasies: somewhere between Daddy Warbucks and Eyes Wide Shut. There is indeed a group of young women—in their twenties and thirties—who act as Epstein's support staff and companions. Some have worked for him for many years, marrying, having children, and continuing as part of his business and household infrastructure. One woman, on an afternoon when I was there, had just returned from an around-the-world honeymoon that Epstein had arranged for her. Some are, or have been, his romantic interests. His present girlfriend, whom he met four years ago at a dinner party in New York, has just graduated dental school. One former girlfriend, Eva Andersson Dubin, a Swedish model and Miss Universe finalist whom Epstein has known for more than thirty years, became a doctor—Epstein sent her to medical school—and married hedge funder Glen Dubin. Together they finance the Dubin Breast Center at Mount Sinai Hospital.

Epstein will sometimes move a meeting in his dining room outside to the park—his idea of going out to lunch is a Sabrett's hot dog—with the various girls in the house the accompanying entourage, as though something out of an 18th-century French court.

But the Hefnerian prurience can also be quite businesslike: poised young women in a mansion on the Upper East Side with various office responsibilities are really not that different from any of the art galleries in the surrounding neighborhood. They mingle freely with his powerful guests, not so much as hostesses—or, in tabloid language, harem-like "sex slaves"—but as attentive students (which, of course, might be regarded as having its own fetish-like attraction). Epstein explicitly denies that there is an sexual quid pro quo. ("If you're screwing someone you work with they can come in late—that's what Jimmy Goldsmith used to say.") Still, the constant attendance of so many comely young women, seems so outside of conventional living or staffing or social or romantic relationships that it is hard to describe in a straightforward or straight-faced way. And while it may be part of the appeal for the men who come to visit Epstein, it is as well a peculiarity they put up with in order to spend time with him.

The Epstein house/office is, by careful design, exclusive and clubby, part hang out, part secret society. Along with the fact that, even after his jail term, the rich and powerful have continued to so eagerly solicit him, it's also notable in the fixed hierarchy of who comes to whose turf, that, when they want to see Epstein, they tend to come to him. He's created a world and you enter it.

His conversations are less meeting-like—focused and agenda-driven—then narrative. In effect: the outside world comes to Epstein's and he eagerly solicits reports. It's a real time newspaper, or the news you don't read in a newspaper, market movements before they occur, the health and eccentricities of world leaders, high level government appointments soon to be announced.

It's Sunday lunch—in his schedule from a week last fall—with Gates, Mort Zuckerman, the real estate billionaire and owner of the Daily News, and Peter Thiel, the PayPal co-founder and early Facebook investor.

That evening its Sheikh Hamad Bin Jassim, the foreign minister of Qatar. Hamad lives across the street in a similarly furnished house—he and Epstein have the same decorator. (Epstein, in his relaxed and amused manner, keeps prodding: "Why are you financing the bad guys? What do you get out of that?")

Next morning, Epstein is joined for breakfast in the dining room by the lawyer Reid Weingarten, who's represented, among other fat cats in trouble, Worldcom's Bernie Ebbers and Goldman Sachs's Lloyd Blankfein. Weingarten, hoarse with a cold, is still lamenting his failed defense of former Connecticut Governor John Rowland. After a blow-by-blow of the trial, they discuss the Qatarian's visit—Epstein served chocolate made from pistachios grown on the Sheikh's farm—and speculate about who actually controls ISIS, with Weingarten arguing that the Turks are not getting enough scrutiny. There is, in Epstein's dining room, always an alternative version of world events—"perception versus reality," says Epstein, "not to imply that one necessarily has greater weight than the other."

"Why," I ask Weingarten, when Epstein briefly steps out of the room, "do so many people keep coming back here, everything considered."

"Why we camp out here? I guess because there's no place like it."

Epstein summons in the next person cooling his heels in the ante-room. It's a young man named Brock Pierce, a former child actor and dotcom high flyer who now describes himself as the "the most active investor" in Bitcoin and the programmable currency space.

After a bit, Epstein invites his next appointment to join them: Larry Summers, the former treasury secretary and President of Harvard, off Diet Coke, digs deep into the Sheikh Hamad chocolates, then focuses in on the Bitcoin investor.

"Okay," he says, after listening for a bit to Pierce and his update on the rapid Bitcoin price swings, "I have opportunities here. But an additional feature of my decision problem, roughly speaking, is that the worst that could happen to you is that you could lose all the money you put into it. Whereas, I could go—I mean I don't look that great now—but I could go from being seen as a figure of some probity and some intelligence to being a figure of much less intelligence and much less probity…"

"Well," says Pierce in seeming dramatic understatement, "you are going to have some low quality characters playing early in the space…"

That evening, in the Epstein dining room (he seems rarely to use the rest of the house's 50,000 square feet), there is a small cocktail party, which includes the former Prime Minister of Australian, Kevin Rudd, and Thorbjørn Jagland, the head of the Nobel Peace Prize Committee, who offers an affable, but generally scathing, critique of U.S. diplomacy (and a brief defense of Obama's Peace Prize award) and to whom Epstein offers a ride back to Europe on his jet.

The next morning, it's Ehud Barack, the former Israeli Prime Minister, for breakfast. Barack is, over his omelet, able to defend both Obama and Putin. Then a high ranking official from the Obama White House, whose name I am asked not to use. There follows the former head of the UN Security Council, Hardeep Purie, and then head of the central bank of Kazakhstan, Kairat Kelimbetov. Then Nathan Myhrvold the former chief technology office at Microsoft. Then Martin Nowak, a Professor of Biology and Mathematics and Director of the Program for Evolutionary Dynamics at Harvard, the institute that Epstein has funded with $30 million. Part of Nowak's research has to do with trying to "describe cancer mathematically." (Epstein preempts Nowak's explanation : “Think of cancer the same way as you think of a terrorist group. The NSA has been able to thwart a great number of terrorism acts by intercepting communication signals from one terrorist to another. That same dynamic, a form of signal intelligence, of finding a terrorist in Europe, can be used to intercept communication between cancer sells. Cancer cells merely communicate in protean code rather than electronic code. If you can decode what the signals are saying you can jam those signal between terrorist calls—essentially wipe out their cell phones. Likewise if you can decode biological signals you can jam them too, that’s the holy grail.”)

Then Richard Axel, a Nobel prize winner in physiology. Then Ron Baron who has $26 billion under management in his Baron Fund. Then Josh Harris, the co-founder of Apollo Global Management ($164 billion under management) and owner of the New Jersey Devils and the Philadelphia 76ers.

The question is why, in the face of such disgrace, with the paparazzi so near, the high and might still come?

Perhaps simply that it’s intelligence of a high order. Not just market moving information, but Epstein and Summers trying to unravel the conundrum of zero interest rates, or Epstein and Noam Chomsky on memory and language, or Epstein TK…

What goes on at Epstein’s house might seem just to confirm everyone's worst fears about power and the powerful: it's all insider stuff. But the conversations at Epstein's are the conversations, I suspect, that rich men dream of, but in the real world, such a buttoned-down and agenda-driven place, are actually hard to have.

"That's Jeffrey," says Mort Zuckerman, (whose paper, the Daily News, is ever vitriolic in its coverage of Epstein), with a twinkle in his eye.

On Epstein's part, there is the wink: In his Paris apartment, 10,000 square feet on the Avenue Foch, a neighborhood otherwise occupied by foreign potentates, there is a stuffed baby elephant in his living room—that is, the *elephant in the room*. (Epstein says too it's a reminder that elephants have 23 copies of tumor suppressor genes and humans have only 1.) The single book on his bedside table is Lolita (he is, beyond the joke, a great Nobokov fan).

Epstein has a yet more structural explanation as to why, after prison and with continuing tabloid infamy, he can maintain his valued place. It comes back, not unexpectedly, to the nature or the needs of money: "At a certain level of finance, almost everyone is allied with an institutional interest. You are part of government, or you want to be in government, or you are connected to a bank or other portfolio, or you have key relationships with certain corporations or industries. Because of my situation, I have none of that. I have no institutional ties which makes me in some sense one of the few wholly independent sources of information and actual honest brokers. That's the usefulness of disgrace."

In some sense, too, it is perhaps generational: Most everyone who is now of a certain age and ambition and status grew up in, and found they were temperamentally suited to, the era of wealth that started in the late 1970s. A meritocracy on steroids, or, as Vanity Fair would baldly dub it, the new establishment, an increasingly parallel world, a self-invented one, at further and further remove from the ordinary one.

Epstein often tells his middle class to riches tale: born in 1953 in Coney Island, father worked for the city's Parks Department, mother a housewife.

The captain of the math team at Lafayette High school in Bensonhurst, he went on to Cooper Union where the tuition is free. He dropped out after two years. Without a college degree, hence by a slight of hand, he got a job teaching math and physics at Dalton in 1974. (A few years ago, during a chance encounter with a former Dalton math department chairman, Margo Gumport, I asked her about Epstein. She said he was the most brilliant math teacher at Dalton in her 50-year career and that she had often wondered what had become of him.)

Dalton fathers perhaps sensed in him a young man on the make. Punch Sulzberger, the publisher of the New York Times, and a Dalton father at the time, tried to recruit Epstein to come to the Times. (Epstein recounts a story of riding with Sulzberger in his wood paneled station wagon to the family's country estate and Sulzberger talking to the chauffer on a phone from the backseat to the front.) Another Dalton father, asking "wouldn't you rather be rich than be a teacher?" introduced him to Bear Stearn's chief Ace Greenberg.

Hence, Epstein, like many in the late '70s, arrived on Wall Street.

If on one side of Wall Street there were the salesmen (the Wolf of Wall Street model), on the other side there was a new sort of finance type able to embrace a level of acute abstraction. "In the past," says Epstein, "investing was all about reputations and relationships. You invested in a company on the basis of who was running it. Did they have integrity? Were they married? Good family men? It was a '50s mentality. But in the mid '70s options started to be traded. In essence, the first formal derivatives. The movement of this instrument is not directly attached to the stock price. The world of investing began turning from relationships to math. In a sense I didn't really make money as much as I tried to create it.."

He soon became the protégée of Jimmy Cayne (also hired by Ace Greenberg on a whim—he met him in a bridge game), who would go on to run Bear and to lose his fortune in Bear's 2006 collapse). Epstein's leave-taking or ouster from Bear was the result of politics, envy, overreaching, or a securities violation, or…unclear. But, no matter, when he left in 1982 he took with him billionaire clients, including Marvin

Davis, a real estate developer who owns Twentieth Century Fox, and Herb Seigel, a major media investor in the 1980s. At this point, Epstein was dating Morgan Fairchild, a television star in the new mega-rich-family soap operas, Dallas and Falcon Crest.

If the '80s were happening pell mell in New York, they were happening at double time and catch up speed in London. "I would head to Kennedy and, on the theory that most important events in one's life are serendipitous, I wouldn't decide where I was going until I got there." Thirty-year-old Epstein was living a Lifestyle of the Rich and Famous (he befriended the show's star, Robin Leach), at English shooting parties and country estates with Saturday night black tie dinners, where he was meeting the over-the-top families of Europe.

At the same time, he was developing a perception, or, at least a market differentiation: the hyper wealthy had different problems than the very wealthy. Dealing with a billion dollars was different from dealing with $100 million. "The traditional wealth service structure, an accountant, and investment advisor, a personal lawyer, and an idiot brother-in-law, became hopelessly outdated as amounts exponentially increased. You can't spend a billion dollars, you can just reallocate it to a different investment class. And you can't give away a billion dollars without a vast staff, in effect going into the business of giving away money, yet another business you are likely to know little about."

For a period, one part of his activities, he says, was recovering monies for countries looted by exiled dictators or military strongmen. Then, in his telling, he was representing a series of vastly wealthy people and families—not just doing their bidding or their investing, but helping them to navigate the ambitions of their wealth. If they had big dreams before, it's nothing to what they can have now.

If early in his career he might have seemed like a sort of George Peppard (there's a physical resemblance) in Breakfast at Tiffany's, a charming hustler, later he's George Peppard in Banacek, a smart and astute operator. At just about this point in the narrative, the incredulity about Epstein began to circulate in social circles. Epstein had acquired the major symbols of wealth but without position, public holdings, or obvious paper trails. His is a questionable substrata of wealth, without institutional credentials or bona fides. He's a freelancer. That's the rub: he doesn't work for anyone.

Sure, Goldman Sachs partners and tech geniuses, they might have stratospheric wealth, but what to make of a Coney Island, Zelig-like no-namer?

In 1994, just at the moment when Prince Charles was on television acknowledging his love for Camilla Parker Bowles, Jeffrey Epstein was sitting with his arm around Princess Diana at a dinner at the Serpentine Galley in London (Diana wearing her "revenge" dress that evening). Graydon Carter, in his second year as editor of Vanity Fair, was also at the dinner. Epstein's rise and Carter's rise are not, with a little critical interpretation, that different. Both are a function of the age of new money, both are helped by strategic relationships with the exceptionally wealthy, both have made themselves up. To say that Epstein, in the company of the Princess, stuck in Carter's craw would be an understatement. Epstein became one of the "what do you know about him" figures in Carter's gossip trail—a story waiting to happen. Carter once advised me not to go to Epstein's house or accept a ride in his car least I risk being blackmailed. ("For what?" I asked Carter. "You can't even begin to imagine," said Carter.)

He joined the board of Rockefeller University. He was suddenly on the Trilateral commission, that cabal of business people who fancy themselves, and who are fancied by conspiracy buffs, as running the world. He bought, from his client Limited Founder Les Wexner, the largest private house in Manhattan. (Rumors will continue for many years, that Wexner owns the house and Epstein is just squatting in it—an 18-year squat.) He bought an airplane. Then another. He expanded his holdings in New Mexico. He began a Xanadu-like refurbishment of his Caribbean Island.

He befriended Bill Clinton in his new after-office life—and that would prove to be quite the fatal pairing.

The post-Monica Clinton, now having pardoned the on-the-lam financier Marc Rich—at this point, before his own rehabilitation, Clinton really is the world's ultimate sleaze ball—was suddenly being ferried around in the jet of…*who* exactly? The New York Post was the first to take formal media note of the Clinton-Epstein connection, hinting at a sex and money bromance. "I suppose travel with Clinton changed the arc of my life," Epstein tells me. "There were, I knew, lots of obvious reasons not to do it, but having the ability to spend 100 hours with a former president just doesn't happen to many people."

I met Epstein around this time, on the flight out to TED. Not long after this trip, Epstein's assistant called to invite me for tea at his house in New York, where Epstein, with what seemed to me little understanding of the subject, began to ask me about media—the upside, downside, and nature of media coverage. (Epstein's flirtation with the media would result in his backing an unsuccessful effort, of which I was a part, to buy New York Magazine in 2004.)

New York magazine was then soliciting him for a profile, as was Vanity Fair, who had assigned the British tabloid journalist, Vicki Ward, to the job. Both profiles—New York's by Landon Thomas—pivot on the Clinton connection and detail the same quandary, how a man without clear institutional bona fides nevertheless achieved such wealth and influence. Epstein, sensing that he might be exposing himself, called Carter and said he was having second thoughts about being a public figure.

"Then you should have lived in a two bedroom apartment in Queens," responded Carter.

And then the real troubles began. Epstein had a prodigious massage parlor outcall habit especially in Palm Beach with its many "Jack Shacks." After Epstein's round of publicity and widely touted association with Clinton, the stepmother of one of the massage parlor girls who went to Epstein's house called the police. The police interviewed the girl—who was TK at the time, but whose website identified her as 18—and the girl supplied the names of other girls, some of whom were also younger than 18.

In the end, the police tracked down 18 girls—nine of whom were under 18; the others were in their 20s and 30s (one woman was in her 60s)—a number of whom gave statements describing happy-ending massages. (Although the nature of the allegations will dramatically grow into threesomes and forced sexual encounters, nobody at this point alleged anything more than this.)

Epstein called in Dershowitz, who flew into Palm Beach to put the local authorities in their place—alienating Palm Beach officialdom—and, further amping up the profile of the case, also brought in Roy Black, the famous criminal attorney who defended William Kennedy Smith in his rape trial in Palm Beach.

The release by the Palm Beach authorities of the depositions by the 18 girls describing the incremental details of the sex acts, the timing of the charges coming just after Rush Limbaugh's high profile Palm Beach drug bust, the Clinton connection and then with the sudden interest of the Bush FBI in the case, moved the case from solicitation to scandal, and a plea deal with a sentence of 18 months.

He got out of jail in 2009, serving 13 months, and moved mostly seamlessly back into his life, to the shock-shock of tabloids whenever they are reminded of his existence (notably, when Epstein's payment of Fergie's debts slipped out, likely leaked by Fergie herself).

Some things changed. While surprisingly few others dropped him, the Clinton's did, an irony of the present tabloid interest in Epstein's old address book with its many Clinton contacts. And his sex offender status has transformed him from libertine playboy to pedophile in tabloid parlance.

While he has regularly entertained PR proposals aimed at his public rehabilitation, until Gates prodded him, and until this recent renewed tabloid fever, Epstein had concluded that he was perfectly satisfied living behind high walls and in his own exclusive club. Even the recent Dershowitz-Prince Andrew chapter seems like a parallel disturbance rather than something that is actually affecting him. "Bad press is not something actually bad," he notes, trying to balance perception and reality.

But true or not, the story has taken on a life of its own, with the US and British tabloid press continuing, so far unsuccessfully, to search for a smoking gun connecting Clinton to underage girls, which could have—many obviously hope—the effect of derailing the Hillary Clinton presidential campaign.

It is a curious attribute of his character that, other than perhaps being more circumspect about what legal advice to follow, Epstein would have done little differently. (When I suggested recently to Epstein that one obvious way to blunt the animus bearing down on him would be to get married, he said he'd rather go back to jail.) His life, living it as he wants, seems to him to be an extraordinary accomplishment. Being on the wrong side of morality, custom, politics, feminists, the media, that's just a bit of bad luck.

And it is perhaps this attitude of his that irks his critics the most. Although he has spent more than a year in jail and paid out what may be as much as $20 million, he yet seems somehow to have gotten away with it—that worst sin of all. He is the unrepentant catchall of up-to-the-minute badness: the financier whose wealth is a product of Wall Street math rather than work; a rich middle-age white man who not only parades his wealth and entitlement, but has a Peter Pan complex to boot; an insistent playboy (excuse me, pedophile) in a correct and prudish world—someone who somehow didn't get the memo about vast changes in mores and culture.

But Epstein's friends—and I think that is, in the end, the best word for the powerful people who orbit him—are willing to take him as he comes. Epstein is their confidant. Not the only nexus of them, but one of them. Dr. Epstein. Lay on my couch. As he is everybody’s confidant, everybody becomes his confidant. This is the back and forth, the power loop. His expertise is knowing what other people know. Which surely offers a unique sense of confidence that it is possible to understand how the world works. And in a time of such radical flux and existential instability, everybody wants to seek out someone who might have some answers or at least make you feel like he does—even, and maybe especially, the rich.

In the last days of my interviews with Epstein, he was called by a particular world-stage individual, among the richest and most powerful—proudly louche himself—who, feeling out of his depth in a world of crashing oil prices and wild currency fluctuation, had come to believe he might benefit from some private tutoring. Epstein welcomed him to the club.

From: Richard Kahn [[redacted]
Sent: 7/22/2015 5:29:11 PM
To: jeffrey E. [jeevacation@gmail.com]
Subject: Republicans gird for the Donald Trump debate

Importance: High

as you predicted..

http://www.politico.com/blogs/media/2015/07/republicans-gird-for-the-donald-trump-debate-211033.html?ml=tl_5_b#

Debate Schedule

August 6, 2015
9pm ET - Republican Primary Debate
Aired On: **Fox News Channel**
Location: **Quicken Loans Arena in Cleveland, OH**
Sponsors: Fox News, **facebook**
Moderators: **Bret Baier, Megyn Kelly and Chris Wallace**
Rules: **Top 10 candidates in an average of 5 national polls**
Candidates**: To be determined**
Notes**: Fox News has added a candidate forum at 1pm ET the same day for candidates who don't make the debate cut**

September 16, 2015
Reagan Library Republican Debate (Press Release)
Aired On: CNN and Salem Radio
Location: Reagan Library in Simi Valley, CA
Sponsors: Reagan Library Foundation, CNN, Salem Media Group
Moderators: Jake Tapper, Hugh Hewitt,
Rules: Split field into Segment B (top 10 candidates) and Segment A (remaining candidates getting at least 1% in polls) (Details)
Candidates: To be determined

October 28, 2015
CNBC Republican Debate
Aired On: CNBC
Location: University of Colorado in Boulder (Press Release)
Sponsors: CNBC (Press Release)
Candidates: To be determined

November, 2015*
Republican Primary Debate
Aired On: Fox Business Network
Location: Wisconsin
Sponsors: Fox Business Network
Candidates: To be determined

December 15, 2015
Republican Primary Debate
Aired On: CNN
Location: Las Vegas, Nevada

Sponsors: CNN, Salem Media Group
Candidates: To be determined

2016

January, 2016*
Republican Primary Debate
Aired On: F**ox News Channel**
Location: Iowa
Sponsors: Fox News
Candidates: To be determined

February 6, 2016
Republican Primary Debate
Aired On: ABC
Location: St. Anselm College in Manchester, New Hampshire
Sponsors: ABC News, IJReview.com (Press Release)
Candidates: To be determined

February 13, 2016
Republican Primary Debate
Aired On: CBS
Location: South Carolina
Sponsors: CBS
Candidates: To be determined

February 26, 2016
Republican Primary Debate
Aired On: NBC and Telemundo
Location: Texas
Sponsors: NBC/Telemundo, National Review
Candidates: To be determined

March, 2016*
Republican Primary Debate
Aired On: Fox News Channel
Location: TBD
Sponsors: Fox News
Candidates: To be determined

March 10, 2016
Republican Primary Debate
Aired On: CNN
Location: Florida
Sponsors: CNN, Salem Media Group
Candidates: To be determined

*Debate sponsor has not yet named specific date

Top 10 Media Stocks for 2015

By Dan Moskowitz | March 19, 2015 AAA |

The following list is broken down into Top-Tier Media Stocks and Speculative Media Stocks. It might surprise you that some of the names on the latter list aren't on the former list, but there is a simple reason for this, which will be revealed below.

Top-Tier Media Stocks

Walt Disney

The Walt Disney Co. (DIS) is one of the strongest brands in the world. It also possesses multiple revenue streams and pricing power. Q1 EPS jumped 23% year over year based on record revenue. When a company delivers record revenue, that trend doesn't make a sudden U-turn. If there's going to be a turnaround for the worse, it will take time to play out, giving you time to exit your position. (For related reading, see: *This Company Is No Mickey Mouse Operation*.)

CBS

CBS Corp.'s (CBS) Q4 revenue increased 3% and diluted EPS improved 8%. CBS also announced a $1 billion share buyback in the first quarter. This will significantly reduce the share count, which should improve earnings. CBS will once again have Thursday Night Football, and it will be the home of Super Bowl 50. It's also home to regular-season NFL games, March Madness and The Masters. However, its reach goes well beyond sports.

Comcast

FY2014 revenue at Comcast Corp. (CMCSA) increased 6.4%. Operating cash flow and EPS improved 6.9% and 25%, respectively. Comcast also increased its dividend 11% and announced that $4.25 billion of its $10 billion share buyback program would take place in 2015. (For more, see: *This Company is as Unavoidable as it is Unloved*.)

Twenty-First Century Fox

Twenty-First Century Fox, Inc.'s (FOXA) Q2 operating income before depreciation and amortization increased 12%. Fox studios enjoyed 24 Academy Award nominations in 2015, making it the industry leader. Twenty-First Century Fox also recently created the Europe's leading pay TV business.

Google

Google Inc. (GOOGL) is known as more of a technology company than a media company, but its YouTube segment consumes approximately 15% of all broadband traffic in the United States and Canada (only Netflix, Inc. (NFLX) is higher at 35%). Google also makes this list because of its $62.63 billion in cash, which means it can enter any business it pleases. If it chooses to expand its media presence, then it would likely steal share from some of the current industry leaders. (For related reading, see: *How Google's Self-Driving Car Will Change Everything*.)

Speculative Media Stocks

Charter Communications

Q4 revenue jumped 9.9% at Charter Communications, Inc. (CHTR) thanks to higher customer penetration on Internet, video, and commercial businesses. Another positive is that Berkshire Hathaway Inc. (BRK.A) recently increased its position in CHTR by adding 1.2 million shares. CHTR now represents 1.35% of the fund's portfolio. The reason CHTR is on the speculative list is a lack of profitability.

Discovery Communications

Differentiation is the key here thanks to Discovery Communications, Inc.'s (DISCA) success with docudramas. In FY2014, revenue increased 13%, adjusted earnings per diluted share improved 13%, free cash flow increased 2%, and $1.4 billion worth of stock was repurchased. The biggest risks here are a challenging U.S. market and currency headwinds. It should also be pointed out that there is an 11% short position on the stock. (For related reading, see: *A Breakdown of Stock Buybacks*.)

Viacom

MTV, VH1, CMT, BET, Nickelodeon, Nick Jr, Comedy Central, TV Land, SPIKE, and more. Do these sound like brands that are likely to suffer? No. Viacom, Inc. (VIA) is a profitable company that pays a small dividend. On the other hand, a debt-to-equity ratio of 3.88 isn't comforting.

Time Warner

Time Warner Inc. (TWX) has 165 channels across 200 countries. This includes HBO. In FY2014, revenue increased 3%. That's not spectacular, but adjusted EPS jumped 18%, which now represents six consecutive years of adjusted EPS growth in the high teens. Time Warner also returned $6.6 billion to shareholders via dividends and buybacks throughout the year. Over the long haul, cable companies will have a difficult time competing against streaming services, but all is okay for right now.

Scripps Networks Interactive

Among Scripps Networks Interactive, Inc.'s (SNI) properties are Home and Garden Television, Food Network, Travel Channel, DIY Network, Cooking Channel and Great American Country. These are strong brands. Strong enough that Scripps Networks expects FY2015 revenue to increase approximately 4%. The company also expects selling, general, and administrative expenses to come in between flat and down 2%. Either way, it's a positive when revenue is outpacing SG&A expenses. Furthermore, Scripps Networks has announced that it's adding $1 billion to its share buyback program and increasing its dividend by 15%. The risk here is the stock's sensitivity to broader market corrections. (For a look back to 2009, see: *Scripps Network Interactive Worth a Look*.)

Performance Comparisons

Another reason why some stocks made the top list and others did not is performance. If a stock can't appreciate in a bull market, then how would you expect it to perform when the trend reverses? Capital preservation should be the number one priority for a savvy investor. Below are total return numbers for each company as of 3/18/2015).

	1-Year	3-Year	5-Year	10-Year
DIS	33.09%	36.87%	27.03%	15.19%
CBS	-3.95%	26.94%	23.19%	12.56%
CMCSA	19.26%	27.62%	23.13%	13.40%
FOXA	6.46%	26.99%	24.13%	8.83%
GOOGL	-6.61%	21.87%	14.84%	20.18%
CHTR	50.27%	43.56%	40.36%	n/a
DISCA	-25.98%	8.93%	13.74%	n/a
VIA	-20.33%	11.19%	17.28%	n/a
TWX	37.35%	38.08%	25.34%	9.86%
SNI	10.10%	15.26%	12.24%	n/a

The Bottom Line

The Top-Tier Media Stocks have outperformed Speculative Media Stocks over the past three years (for the most part). Therefore, you should strongly consider the first set of stocks listed above. While it's entirely possible they all underperform in 2015 if the market falters, these are elite names that are highly likely to be around for a long time. Even if the worst occurs, you will have an opportunity to add more to your position at cheaper prices. (For related reading, see: *Buying Facebook Stock, A Beginner's Guide*.)

Read more: http://www.investopedia.com/articles/active-trading/031915/top-10-media-stocks-2015.asp#ixzz3gdqLDgWm
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Internet & Society: The Technologies and Politics of Control

Professor Jonathan Zittrain co-taught with Professor Joi Ito, Director of the MIT Media Lab
Harvard Law School
Winter 2017

Mon-Fri
10:30am-noon; 12:45pm-2pm
Milstein West AB

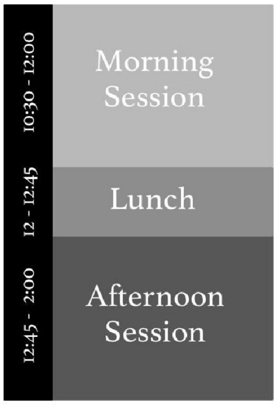
Syllabus

I. Course Description

This course offers a rigorous introduction to the field of cyberlaw. We will investigate the evolving nature of online architecture and activities, and the ways in which law has been, and will be, leveraged to influence them.

Course themes include the complex interaction between Internet governance organizations and sovereign states, the search for balance between the ease of disseminating information online and the interest of copyright holders, privacy advocates, and others in controlling that dissemination, and the roles of intermediaries and platforms in shaping what people can and cannot do online. The course will include an array of learning and teaching methods. Students will be expected to participate in a variety of activities.

II. Class Schedule



The class meets every day from January 3rd to January 13th in Milstein West AB. Each day will be divided into three phases: the morning session from 10:30am to noon, lunch from noon to 12:45pm, and the afternoon session from 12:45pm to 2pm. Lunch will be provided.

A more detailed schedule of the topics we will be covering each day follows below.

Topics (2 per day other than the last day)

Day 1: Introduction, Right to Be Forgotten and Jurisdiction
Day 2: Copyright, DRM debate between Professor Ito and Professor Zittrain (afternoon session)

Day 3: Cryptocurrency
Day 4: Private Infrastructures for Government Surveillance, John DeLong/Bruce Schneier talk (morning session)
Day 5: Net Neutrality and Internet Architecture, Dialogue with Andy Ellis (afternoon session)
Day 6: Weaponized Social, Open discussion with John Palfrey (morning session)
Day 7: Free vs. Proprietary Code and Content, Dialogue with David Clark (afternoon session)
Day 8: Governance, Artificial Intelligence
Day 9: Conclusion

III. Class Requirements

The purpose of this class is to give students a sense of the historical battles of the Internet, what different actors were thinking, what they were trying to accomplish, and what levers they pulled in order to select for specific outcomes. Students should apply what they have learned from historical examples to a current Internet issue discussed in class and describe in a 12-15 page paper what a viable solution might look like. Solutions could take the form of a policy recommendation, project proposal, or code. The paper or project proposal will be due on Friday, January 20th, and may be submitted by email to Samantha Bates at sbates@law.harvard.edu.

IV. Class Materials

There is no required textbook for this class. All readings will be available online on the class H2O playlist: https://h2o.law.harvard.edu/playlists/51511.

We will have a slack channel for the class. Please click on the following link to sign up: https://internet-society2017.slack.com/signup.

Students should bring their laptops to class to use for daily activities, but all electrical devices must remain off during lectures.

V. General Information

Professor Zittrain and Professor Ito will be available for group office hours after class on the following dates:

- Wednesday, January 4th from 2:15-3:15pm in Milstein West.
- Monday, January 9th from 2:15-3:15pm in Milstein West.
- Wednesday, January 11th from 2:15-3:15pm in Milstein West.

For other general scheduling/appointment questions, please contact:

Amanda McMahan
Assistant to Professor Zittrain
Office Phone: [redacted]
Email: [redacted]
Office location: Griswold Hall, 5th floor, Room #505

Yuko Barnaby
Assistant to Media Lab Director Ito
Office Phone: [redacted]
Email: [redacted]
Office location: MIT Media Lab, E-14, Director's Office 245

For course related (readings/paper) questions, please contact:

Samantha Bates
Research Associate
Email: [redacted]

Natalie Saltiel
Coordinating Editor for the Journal of Design and Science (JoDS)
MIT Media Lab
Email: [redacted]

For other information about the class, please contact:

Shailin Thomas
Teaching Fellow
Email: [redacted]

Jordi Weinstock
Visiting Scholar
Email: [redacted]

Reading Assignments

Day 1: Introduction

Welcome! We aspire to the implausible: a nine-day introduction to the unusual dynamics of the world's digital space, sufficient for a strategic understanding of what makes it difficult (but far from impossible) to regulate or shape; who's trying to do it nonetheless; and how such efforts have fared over the past twenty years, with an eye towards lessons for influencing the space and the behavior within it today.

In addition to offering some frameworks for thinking about Internet architecture and policy, and the curious open and generative nature of the phenomenon, we will delve into the net as a contingently global phenomenon, and the way that complicates regulation by traditional sovereigns. Our case study will be the current debates around implementation of Europe's "right to be forgotten" in search engine results. As you complete the readings, you might see how you'd answer the question of what a state like France's view should be towards the scope of its RTBF regulation, and whether the kind of "zoning" described in the Cato Institute article from thirteen years ago (!), is realizable and desirable.

Readings:

- C.P. Snow, "The Rede Lecture: The Two Cultures," (1959) pages 1-9 http://s-f-walker.org.uk/pubsebooks/2cultures/Rede-lecture-2-cultures.pdf archived at https://perma.cc/XB6F-N9K8.
- John Perry Barlow, "A Declaration of the Independence of Cyberspace," *Electronic Frontier Foundation* (February 8, 1996) https://www.eff.org/cyberspace-independence archived at https://perma.cc/H2CZ-N2EX.
- Locke, Levine, Searles, & Weinberger, The Cluetrain Manifesto: 95 Theses (1999) http://www.cluetrain.com/book/95-theses.html archived at https://perma.cc/2BLT-6ZEL.
- Jonathan Zittrain, *The Future of the Internet and How to Stop It*. New Haven: 2008 https://dash.harvard.edu/bitstream/handle/1/4455262/Zittrain_Future%20of%20the%20Internet.pdf?sequence=1 archived at https://perma.cc/NM9D-7Y2V.
    - Read pages 1-5, 7-9, 57-61, 63-65, 67-71.
- Yochai Benkler, *The Wealth of Networks*. New Haven: 2006. http://www.benkler.org/Benkler_Wealth_Of_Networks.pdf archived at https://perma.cc/BC4A-96KP.
    - Read pages 154 (beginning "Imagine a world") - 161

Jurisdiction

- Jonathan Zittrain, "Be Careful What You Ask For: Reconciling a Global Internet and Local Law," WHO RULES THE NET?, Cato Institute (2003) http://cyber.law.harvard.edu/sites/cyber.law.harvard.edu/files/2003-03.pdf archived at https://perma.cc/3JE9-GM3R.

[OPTIONAL: Right to Be Forgotten readings]

- Zoe Bedell, “Google to France: ‘Forget You’ - An Update on the Right to Be Forgotten” *Lawfare* (May 25, 2016) https://www.lawfareblog.com/google-france-forget-you-%E2%80%93-update-right-be-forgotten archived at https://perma.cc/W9EX-5AGZ.
- Google Spain v. Mario Costeja González ECJ opinion (May 13, 2014) http://curia.europa.eu/juris/document/document_print.jsf?doclang=EN&docid=152065 archived at https://perma.cc/3ARS-3XC4.
    - Read paragraphs 89-99
- Brendan van Alsenoy and Marieke Koekkoek, The Extraterritorial Reach of the EU’s ‘Right to Be forgotten’ (January 19, 2015). CiTiP Working paper 20/2015. Available at SSRN: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2551838 archived at https://perma.cc/B3SF-YJ3W.
    - Read pages 3-22

Day 2: Copyright

Copyright was once thought of as the defining battle of consumer networking. Academic technologies brought into the mainstream made it trivial to prepare and distribute perfect copies of copyrighted work without permission -- and the comparatively powerful organizations representing copyright holders saw this as an existential threat.

We will read some of the “grim joy” experienced by Internet freedom types in dancing on the grave of copyright in the mid-1990s -- and immerse in some of the law and policy changes effected in the United States to deal with the problem without running up against the equities of rapidly-growing intermediaries of online and Internet service providers (turns out, there’s a difference).

The copyright wars revealed a variety of strategies that we’ll look at with the benefit of years of hindsight, including lawsuits against network providers, software makers, and individual users both sending and receiving files, as well as technical changes designed to make it more difficult to share items that wish not to be shared. Ultimately we are drawn to the question of whether the wars were won by one side or another, or whether it’s more accurate to say that they simply faded away. What issues today feel make-or-break, yet could simply fade rather than be resolved, and why?

We’ll end the day with a peek into, and practice of, a current intense if obscure debate: that of whether digital rights management hooks should be placed into standards for Web browsers.

Readings:

- John Perry Barlow, “The Economy of Ideas,” *Wired* (March 1994) http://archive.wired.com/wired/archive/2.03/economy.ideas.html?topic=&topic_set= archived at https://perma.cc/P82S-RZP3.

- Matthew Green, Napster Opens Pandora's Box: Examining How File-Sharing Services Threaten the Enforcement of Copyright on the Internet, 63 Oh. St. L. J. 799 (2002) http://moritzlaw.osu.edu/students/groups/oslj/files/2012/03/63.2.green_.pdf archived at https://perma.cc/H77J-TN43.
- Brad Hill, "The iTunes Influence, Part I: How Apple Changed the Face of the Music Marketplace," *Engadget* (April 29, 2013) https://www.engadget.com/2013/04/29/the-itunes-influence-part-one/ archived at https://perma.cc/MEU4-W5N9.
- David Kravets, "10 Years Later, Misunderstood DMCA is the Law That Saved the Web," *Wired* (October 27, 2008) https://www.wired.com/2008/10/ten-years-later/ archived at https://perma.cc/VH2T-7S7V.
- Lawrence Lessig, The Creative Commons, 55 Fla. L. Rev. 763 (2003) http://homepages.law.asu.edu/~dkarjala/OpposingCopyrightExtension/commentary/LessigCreativeCommonsFlaLRev2003.htm archived at https://perma.cc/T7UD-JHYZ.
- Alex Davies, "The EPA Opposes Rules That Could've Exposed VW's Cheating," *Wired* (September 18, 2015) https://www.wired.com/2015/09/epa-opposes-rules-couldve-exposed-vws-cheating/ archived at https://perma.cc/W4RK-Q6QJ.

DRM and HTML5 background readings:

- "Information about W3C and Encrypted Media Extensions (EME)" W3C (March 2016) https://www.w3.org/2016/03/EME-factsheet.html archived at https://perma.cc/4ZPR-DXTA.
- Peter Bright, "DRM in HTML5 is a victory for the open Web, not a defeat," *Ars Technica* (May 10, 2013) http://arstechnica.com/business/2013/05/drm-in-html5-is-a-victory-for-the-open-web-not-a-defeat/ archived at https://perma.cc/UM8C-NFPV.

Day 3: Cryptocurrency

One view of the progression of digital technology has been roughly from amateur to professional, from open to closed, and from chaotic to ordered -- as the early successes from left field of Google, Facebook, and Twitter enter publicly-traded adulthood. At the ripe year of 2017, are there still digital disruptions to be had?

The phenomenon (and increasing literal value) of cryptocurrency -- and, for that matter, the foundational blockchain technologies on which it can be based -- seems to indicate that there are still surprises from left field. What does the rise of cryptocurrency tell us about the state of cyberspace, and what should we expect -- and hope for -- next?

Readings:
Introduction

- Coin Center, Blockchain 101, https://coincenter.org/learn archived at https://perma.cc/M2TZ-B9YX.
- Eli Dourado and Jerry Brito, "The New Palgrave Dictionary of Economics: cryptocurrency," Online Edition, 2014 http://coincenter.org/wp-content/uploads/2015/05/cryptocurrency-article.pdf archived at https://perma.cc/3YFE-QS5P.
- Joel Monegro, "The Blockchain Application Stack" http://www.coindesk.com/blockchain-application-stack/ archived at https://perma.cc/4E3V-SCAL.

[OPTIONAL: for a more in depth technical introduction to Bitcoin]

- Michael Nielson, "How the Bitcoin Protocol Actually works" http://www.michaelnielsen.org/ddi/how-the-bitcoin-protocol-actually-works/ archived at https://perma.cc/C2QJ-YFEY.

Bitcoin & the Blockchain

- Joi Ito, "Why Bitcoin is and isn't like the Internet" https://joi.ito.com/weblog/2015/01/23/why-bitcoin-is-.html archived at https://perma.cc/CBE8-2UXQ.
- Joi Ito, "Why anti-money laundering laws and poorly designed copyright laws are similar and should be revised," (March 12, 2016) http://pubpub.ito.com/pub/dmca-drm-aml-kyc-backdoors archived at https://perma.cc/7T7T-UPJK.
- Rachel O'Dwyer, "The Revolution Will Not Be Decentralized: Blockchains," *Common Transition* (June 11, 2015) http://commonstransition.org/the-revolution-will-not-be-decentralised-blockchains/ archived at https://perma.cc/MNP7-JZZL.
- Vili Lehdonvirta and Edward Castronova, *Virtual Economies: Design and Analysis.* 2014. MIT Press.
  - Read Chapter 10: Money
- Raskin, Max and Yermack, David, Digital Currencies, Decentralized Ledgers, and the Future of Central Banking (May 1, 2016). Peter Conti-Brown & Rosa Lastra (eds.), Research Handbook on Central Banking, Edward Elgar Publishing, Spring 2017, Forthcoming. Available at SSRN: https://ssrn.com/abstract=2773973 archived at https://perma.cc/FTC3-M6EF.

Ethereum

- Vitalik Buterin, "What is Ethereum?," *Coin Center* https://coincenter.org/entry/what-is-ethereum archived at https://perma.cc/WKN4-33XF.

Smart Contracts

- Houman Shadab,"What are Smart Contracts and What Can We do with Them?," *Coin Center* (December 15, 2014) https://coincenter.org/entry/what-are-smart-contracts-and-what-can-we-do-with-them archived at https://perma.cc/BH6T-J6S7.

[OPTIONAL]

- Arvind Narayanan; "What Happened to the Crypto Dream, Part 1," Co-published by the IEEE Computer and Reliability Societies (March/April 2013) http://randomwalker.info/publications/crypto-dream-part1.pdf archived at https://perma.cc/DX8U-QJ5A.
- Arvind Narayanan, "What Happened to the Crypto Dream?, Part 2," Co-published by the IEEE and Reliability Societies (May/June 2013) http://randomwalker.info/publications/crypto-dream-part2.pdf archived at https://perma.cc/F482-84AY.
- Lawrence Lessig Code 2.0 lecture from COALA Blockchain Workshop: https://www.youtube.com/watch?v=pcYJTIbhYF0.
- Chelsea Barabas and Ethan Zuckerman, "Can Bitcoin be used for Good?," *The Atlantic* (April 7, 2016) http://www.theatlantic.com/technology/archive/2016/04/bitcoin-hype/477141/ archived at https://perma.cc/V94Q-CCP3.

Day 4: Private Infrastructures for Government Surveillance

Digital privacy has at times been understood as privacy against corporate intrusion (think ad networks); against government (think the various government intelligence-gathering establishments around the world); and against one another (think drones as well as more pedestrian technologies that empower people to document facts about, or even doxx, each other).

This session will look at the second form of surveillance, especially as effectuated through the cooperation or compulsion of private intermediaries. How successful is such surveillance, and will it continue to be effective as the public reacts by potentially adopting privacy-enhancing tools? How successful do we want it to be, and how might frameworks agreeable within jurisdictions that embrace the rule of law be used or abused within those that do not?

Readings:

- David O'Brien, Matt Olsen, Bruce Schneier, and Jonathan Zittrain, et al. "Don't Panic. Making Progress on the 'Going Dark' Debate," The Berkman Center for Internet & Society at Harvard University (Feb 1, 2016) https://cyber.law.harvard.edu/pubrelease/dont-panic/Dont_Panic_Making_Progress_on_Going_Dark_Debate.pdf archived at https://perma.cc/NT9M-ELAG.
- John Cassidy, "Lessons from Apple vs. The F.B.I.," *The New Yorker* (March 29, 2016) http://www.newyorker.com/news/john-cassidy/lessons-from-apple-versus-the-f-b-i archived at https://perma.cc/282P-A7MS.

- Susan Landau, Testimony for House Judiciary Committee Hearing on "The Encryption Tightrope: Balancing Americans' Security and Privacy" (March 1, 2016) https://judiciary.house.gov/wp-content/uploads/2016/02/Landau-Written-Testimony.pdf archived at https://perma.cc/N9D9-JTYQ.
- Bruce Schneier, "Data Is a Toxic Asset, So Why Not Throw It Out?," *Schneier on Security* (March 1, 2016) https://www.schneier.com/essays/archives/2016/03/data_is_a_toxic_asse.html archived at https://perma.cc/7NUL-W5YJ.
- Stewart Baker, "Why the NSA Needs Your Phone Calls…and why you (probably) shouldn't worry about it," *Foreign Policy* (June 6, 2013) http://foreignpolicy.com/2013/06/06/why-the-nsa-needs-your-phone-calls/ archived at https://perma.cc/YE3N-TSWU.
- [OPTIONAL] Harold Abelson et al., "Keys Under Doormats: Mandating insecurity by requiring government access to all data and communications," CSAIL (Jul 7, 2015). https://www.schneier.com/academic/paperfiles/paper-keys-under-doormats-CSAIL.pdf archived at https://perma.cc/2L3U-QST8.

Day 5: Internet Architecture/Net Neutrality

We increasingly assume the availability of commodity networking -- a flat fee for access -- even as the way in which we experience the Internet is evolving through a curious microeconomics, a mishmash of policies designed to subsidize or regulate access, and a sometime ability to arbitrage around arrangements through technologies to facilitate access sharing and virtual tunneling.

How is Internet access likely to evolve, and what choices exist for polities with particular ideals about how it should work?

Discussion will include Andy Ellis, Berkman Klein Center Fellow and CSO of Akamai, one of the most important companies that people haven't heard of.

Readings:
Net Neutrality

- [FOR REFERENCE] Net Neutrality timeline, Public Knowledge: http://whatisnetneutrality.org/timeline archived at https://perma.cc/L8JE-QYP8.
- Tim Wu, Network Neutrality, Broadband Discrimination. Journal of Telecommunications and High Technology Law, Vol. 2, p. 141 (2003). Available at SSRN: https://ssrn.com/abstract=388863 or http://dx.doi.org/10.2139/ssrn.388863 archived at https://perma.cc/X856-RWSC.
    - Read the introduction and Part I A, pages 141-147.
- Tim Wu and Christopher Yoo, "Keeping the Internet Neutral?: Tim Wu and Christopher Yoo Debate," Federal Communications Law Journal. 59 (2007), pp. 575-592

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=953989 archived at https://perma.cc/FHE3-XUED.

- Tom Wheeler, "This is How We Will Ensure Net Neutrality," *Wired* (February 4, 2015) https://www.wired.com/2015/02/fcc-chairman-wheeler-net-neutrality/ archived at https://perma.cc/C8DE-2PJB.

Zero-rating

- Jeremy Malcolm, Corynne Mcsherry, and Kit Walsh, "Zero rating: What It Is and Why You Should Care," *Electronic Frontier Foundation* (February 18, 2016) https://www.eff.org/deeplinks/2016/02/zero-rating-what-it-is-why-you-should-care archived at https://perma.cc/Y6TW-2QAG.
- Arturo J Carrillo, Having Your Cake and Eating it Too? Zero-Rating, Net Neutrality and International Law (March 6, 2016). 19 Stan. Tech. L. Rev. 364 (2016). Available at SSRN: https://ssrn.com/abstract=2746447 archived at https://perma.cc/9Z28-X6A4.
    - Read part IV (pages 418-428).

Internet Architecture

- Mike Masnick, "Can We Kill This Ridiculous Shill-Spread Myth That CDNs Violate Net Neutrality? They Don't," *TechDirt* (August 13, 2014) https://www.techdirt.com/articles/20140812/04314528184/can-we-kill-this-ridiculous-shill-spread-myth-that-cdns-violate-net-neutrality-they-dont.shtml archived at https://perma.cc/YK3D-3BQG.

Day 6: Weaponized Social

The time when the solution to bad speech could be advanced as simply more speech might seem quaint. The famously libertarian Electronic Frontier Foundation recently released a white paper in which it acknowledged a line between a clash of ideas and flat-out harassment, with the latter causing less rather than more robust debate. Separately, concerns about outright false news that spreads virally have inspired calls for action by intermediaries like Facebook -- a self-described technology, rather than media, company.

Applying lessons from the conflicts of the past two decades online, how might we agree upon a vision for social networking even if we disagree on many substantive issues to be debated there, and what are the roles, if any, of regulators and private platforms in establishing boundaries on behavior online through code or legal sanction?

Is it more difficult to agree on a vision is our media is no longer *about* the battlefield or the real world but *is* the battlefield and the real world?

Readings:

The Problem

- Eugene Volokh, “No, there’s no ‘hate speech’ exception to the First Amendment,” *The Washington Post* (May 7, 2015) https://www.washingtonpost.com/news/volokh-conspiracy/wp/2015/05/07/no-theres-no-hate-speech-exception-to-the-first-amendment/?utm_term=.78330882267d archived at https://perma.cc/A5ES-HMQE.
- Jon Ronson, “How One Stupid Tweet Blew Up Justine Sacco’s Life,” *The New York Times Magazine* (February 12, 2015) http://www.nytimes.com/2015/02/15/magazine/how-one-stupid-tweet-ruined-justine-saccos-life.html?_r=0 archived at https://perma.cc/3AHS-Z9EU.
- Adrian Chen, “The Agency,” *The New York Times Magazine* (June 2, 2015) http://www.nytimes.com/2015/06/07/magazine/the-agency.html?_r=0 archived at https://perma.cc/BER2-TD6E.
- Reeves Wiedeman, “The Sandy Hook Hoax,” *The New York Magazine* (September 5, 2016) http://nymag.com/daily/intelligencer/2016/09/the-sandy-hook-hoax.html archived at https://perma.cc/T9YD-U8Z9.
- Gilad Lotan, “Fake News Is Not the Only Problem,” *Points* (November 22, 2016) https://points.datasociety.net/fake-news-is-not-the-problem-f00ec8cdfcb#.kwt01pk4h archived at https://perma.cc/B3FK-FJVX.
- Craig Silverman, “How Teens In The Balkans Are Duping Trump Supporters With Fake News,” *BuzzFeed* (November 3, 2016) https://www.buzzfeed.com/craigsilverman/how-macedonia-became-a-global-hub-for-pro-trump-misinfo?utm_term=.nlpEm5kbY#.apomjgWlD archived at https://perma.cc/SB2G-9XUM.
- Caitlin Dewey, “Facebook fake-news writer: ‘I think Donald Trump is in the White House because of me,’” *The Washington Post* (November 17, 2016) https://www.washingtonpost.com/news/the-intersect/wp/2016/11/17/facebook-fake-news-writer-i-think-donald-trump-is-in-the-white-house-because-of-me/?utm_term=.e2d9c7b0d5e6 archived at https://perma.cc/B6S4-UBJC.

The Search for Solutions

- Andy Greenberg, “Inside Google’s Internet Justice League and Its AI-Powered War on Trolls,” *Wired* (September 19, 2016) https://www.wired.com/2016/09/inside-googles-internet-justice-league-ai-powered-war-trolls/ archived at https://perma.cc/K56R-MGBX.
- Dia Kayyali and Danny O’Brien, “Facing the Challenge of Online Harassment” *Electronic Frontier Foundation* (January 8, 2015) https://www.eff.org/deeplinks/2015/01/facing-challenge-online-harassment, archived at https://perma.cc/98RS-L876.
- State v. Robert Bishop, 223PA15 (June 10, 2016) https://h2o.law.harvard.edu/collages/42536.

Day 7: Free vs. Proprietary Code and Content

This day examines quite different models for the development and distribution of software -- which can also serve as models for hardware, and for content. What kind of ecosystem, featuring what models, is desirable?

We will think about current issues in cybersecurity as a case study in why free vs. proprietary code might matter, and take up the question of how regulation might be applied when there *are* no easily identified intermediaries in the production of code.

And we will hear from the legendary David Clark, one of the framers of the Internet.

Readings:

- Richard Stallman, "Original Announcement of the GNU Project," GNU Operating System (September 27, 1983) https://www.gnu.org/gnu/initial-announcement.html archived at https://perma.cc/2V5W-89P3.
- The Free Software Foundation, "What is free software?," GNU Operating System http://www.gnu.org/philosophy/free-sw.html archived at https://perma.cc/7884-5ZUR.
    - [FOR REFERENCE] The Free Software Foundation, "Categories of Free and nonfree software," GNU Operating System: https://www.gnu.org/philosophy/categories.html archived at https://perma.cc/HH79-6YVX.
- Jonathan Zittrain, *The Future of the Internet and How to Stop It*. New Haven: 2008 https://dash.harvard.edu/bitstream/handle/1/4455262/Zittrain_Future%20of%20the%20Internet.pdf?sequence=1 archived at https://perma.cc/B7RL-JRKK.
    - Read Chapter 4: Generative Patterns (pages 67-100).
- Jeff Atwood, "Tivoization and the GPL," *Coding Horror* (February 18, 2008), https://blog.codinghorror.com/tivoization-and-the-gpl/ archived at https://perma.cc/YFQ5-42XW.
- Rusty Foster, "The Internet's Telltale Heartbleed," *The New Yorker* (April 9, 2014) http://www.newyorker.com/tech/elements/the-internets-telltale-heartbleed archived at https://perma.cc/AC9L-HW34.
- Ron Amadeo, "Google's iron grip on Android: Controlling open source by any means necessary," *Ars Technica* (October 20, 2013) http://arstechnica.com/gadgets/2013/10/googles-iron-grip-on-android-controlling-open-source-by-any-means-necessary/ archived at https://perma.cc/QKW2-3EQH.
- [OPTIONAL] Open Source Licenses: Richard Fontana et. al, *A Legal Issues Primer For Open Source and Free Software Projects*. Software Freedom Law Center (June 4, 2008) https://www.softwarefreedom.org/resources/2008/foss-primer.pdf archived at https://perma.cc/2CMH-UP4G.
    - Read Chapter 2 only.

Artificial Intelligence

- Joichi Ito, *Extended Intelligence* (February, 2016) http://www.pubpub.org/pub/extended-intelligence.
- Joichi Ito, *Society in the Loop* (June 23, 2016) https://joi.ito.com/weblog/2016/06/23/society-in-the-.html archived at https://perma.cc/AU7Y-BABZ.
- Kevin Kelly, "The Three Breakthroughs That Have Finally Unleashed AI on the World," *Wired* (October 17, 2014) https://www.wired.com/2014/10/future-of-artificial-intelligence/ archived at https://perma.cc/CA2Y-3T58.
- Kate Crawford and Ryan Calo, "There is a Blind Spot in AI Research," *Nature* (October 13, 2016) http://www.nature.com/news/there-is-a-blind-spot-in-ai-research-1.20805 archived at https://perma.cc/5EZ5-HWQJ.
- Azim Shariff, Iyad Rahwan and Jean-François Bonnefon, "Whose Life Should Your Car Save?" *The New York Times (*November, 3, 2016) http://www.nytimes.com/2016/11/06/opinion/sunday/whose-life-should-your-car-save.html
- John Danaher, "Is Effective Regulation of AI Possible? Eight Potential Regulatory Problems" *Philosophical Disquistions* (July 7, 2015) http://philosophicaldisquisitions.blogspot.com/2015/07/is-effective-regulation-of-ai-possible.html archived at https://perma.cc/2GBN-FVMM.
- John Danaher, "Is Anyone Competent to Regulate Artificial Intelligence?" *Philosophical Disquistions* (November 16, 2015) http://philosophicaldisquisitions.blogspot.ie/2015/11/is-anyone-competent-to-regulate.html archived at https://perma.cc/LZ9L-HZJY.

Day 9: Conclusion

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Feds explain sweet deal for billionaire sex offender Epstein

By JANE MUSGRAVE
The Palm Beach Post

WEST PALM BEACH, Fla. — Federal prosecutors in Florida went on the offensive this month, denying allegations that they bowed to pressure from billionaire Jeffrey Epstein — a resident of the Virgin Islands and Palm Beach, Fla. — and his high-priced lawyers at the expense of dozens of teenage girls he sexually abused.

Jeffrey Epstein

In their first public comment since 2007 — when they negotiated a deal that allowed Epstein to escape federal charges — prosecutors filed hundreds of pages of documents in U.S. District Court, explaining what led to the now infamous non-prosecution agreement that has been decried as "a sweetheart deal."

Contrary to claims by attorneys representing two of Epstein's victims in a lawsuit against the federal government, Assistant U.S. Attorney Marie Villafana said she and her superiors were trying to help the traumatized young women when they agreed to let Epstein plead guilty to state prostitution charges.

Contrary to claims by attorneys representing two of Jeffrey Epstein's victims in a lawsuit against the federal government, Assistant U.S. Attorney Marie Villafana said she and her superiors were trying to help the traumatized young women when they agreed to let the now 64-year-old money manager plead guilty to state prostitution charges.

The now-64-year-old money manager, who spends most of his time on his estate Little Saint James in the territory, served 13 months of an 18-month sentence in the Palm Beach County Stockade. He was allowed to leave each day to go to work.

Hoping to persuade U.S. District Judge Kenneth Marra to throw out the lawsuit that accuses the government of violating the federal Crime Victims Rights Act, Villafana said she tried to keep Epstein's victims informed about the investigation and the eventual plea deal. But, she said, negotiations were sensitive and neither Epstein, his victims nor their attorneys made it easy.

For instance, she said, most of the young women were extremely reluctant — or simply refused — to testify against Epstein, who had paid them to give him sexually-charged massages at his mansion.

One of the women who is now suing the government insisted Epstein never abused her, Villafana wrote in a sworn affidavit.

"I hope Jeffrey, nothing happens to Jeffrey because he's an awesome man and it would really be a shame," the woman, identified only as Jane Doe 2, told FBI agents in 2007.

While Villafana said she didn't believe her, she also understood the young woman's suffering. Further, she knew she couldn't force her or Epstein's more than two dozen other victims to testify against him.

Jane Doe 1, who is also suing the government, agreed to testify. But Villafana said one victim wouldn't have been enough to convict Epstein.

Rather than let Epstein use his considerable influence to evade prosecution, she and top officials at the U.S. Justice Department crafted the plea deal.

In exchange for pleading guilty to charges of solicitation of prostitution and soliciting minors to engage in prostitution in Palm Beach County Circuit Court, Epstein was not charged with any federal counts. As part of the agreement, Epstein had to register as a sex offender and agree to settle civil lawsuits that his roughly 30 victims filed against him.

Getting Epstein to agree to pay restitution to his victims and register as a sex offender were key, Villafana wrote. Prosecutors wanted to assure his victims that they would be compensated and that "other minors throughout the country" would be protected, she wrote.

But shortly after Epstein signed the agreement on Sept. 24, 2007, he began fighting it, she said. He and his legal team, including former U.S. Solicitor General Kenneth Starr, whose investigation led to President Bill Clinton's impeachment, contacted high-level justice department officials. They challenged the terms of the non-prosecution agreement.

Fearing it was falling apart, Villafana said her office and the FBI resumed the investigation and informed the victims of that by letter in January 2008.

In their lawsuit, the victims' attorneys, Bradley Edwards and Paul Cassell, say the letter is evidence of their claim that prosecutors lied to the victims. They also claim that prosecutors never told Epstein's victims about the plea deal.

Villafana said she didn't tell the young women about the terms of the agreement, fearing Epstein's attorneys would use it to crush them if federal charges were filed and the case went to trial. Savvy attorneys would argue that the women were testifying against Epstein because federal prosecutors told them they would get paid restitution if they did, she said.

When she learned Epstein planned to plead guilty to the two charges in circuit court on June 30, 2008, Villafana said she immediately notified Edwards. She said she told him to alert his clients so they could attend the hearing. None did.

Cassell, a law professor at the University of Utah, shrugged off the government's new claims, calling them "meritless." A written response will be filed at the end of July, he said.

WEDNESDAY LOCALS NITE
TOP NOTCH
AMAZING SUNSETS GREAT FOODS
LIVE ENTERTAINMENT 6 - 9 PM
RIDE THE VIEW
SKYRIDE TO PARADISE POINT

BRING YOUR HOME TO LIFE!
Home Security Automation, Panic/Duress Hold Up Buttons, Hands-Free Voice Control, Total Connect WiFi Cameras, Video Viewing, Recording & More!
ADT
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Keep an eye on your home from any remote location, with any SmartPhone. Check up on kids, babysitters, elderly relatives, pets, housekeepers, contractors and more
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BLOCKCHAIN CAPITAL, LLC

CCP II, LP

OCTOBER 2015

BLOCKCHAIN
CAPITAL

ONE FERRY BUILDING, SUITE 255 SAN FRANCISCO, CA 94111 investor@blockchain.capital

TECHNOLOGY THOUGHT-LEADERS ARE CONVINCED

Bill Gates:

> “Bitcoin is better than currency…a technological tour de force.”

Ben Bernanke

> “[Virtual Currencies] may hold long-term promise, particularly if the innovations promote a faster, more secure and more efficient payment system.”

Eric Schmidt

> “Bitcoin is a remarkable cryptographic achievement and the ability to create something that is not duplicable in the digital world has enormous value.”

Milton Friedman (1999)

> “I think the Internet is going to be one of the major forces for reducing the role of government… The one thing that’s missing, but that will soon be developed, is a reliable e-cash”

Peter Thiel

> “I do think Bitcoin is the first encrypted money that has the potential to do something like change the world.”

Al Gore

> “I’m a big fan of Bitcoin…Regulation of money supply needs to be depoliticized”

David Marcus (former CEO PayPal)

> “I really like Bitcoin. I own Bitcoins. It’s a store of value, a distributed ledger. It’s a great place to put assets."

INCUMBENTS EMBRACING THE BLOCKCHAIN

NASDAQ - partnered with Chain to launch private company exchange

"As blockchain technology continues to redefine not only how the exchange sector operates, but the global financial economy as a whole, NASDAQ aims to be at the center of this watershed development," - Robert Greifeld, NASDAQ CEO,

Citi - launched "Citicoin" project

"Blockchain technology not only has an opportunity to transform financial services but also extend far beyond payments to new use-cases and applications across industries," - Debby Hopkins, Chief Innovation Officer at Citi

Santander - published: "Fintech 2.0 Paper: Rebooting Financial Services"

"Blockchain technologies could reduce banks' infrastructural costs by $15-20bn a year by 2022"

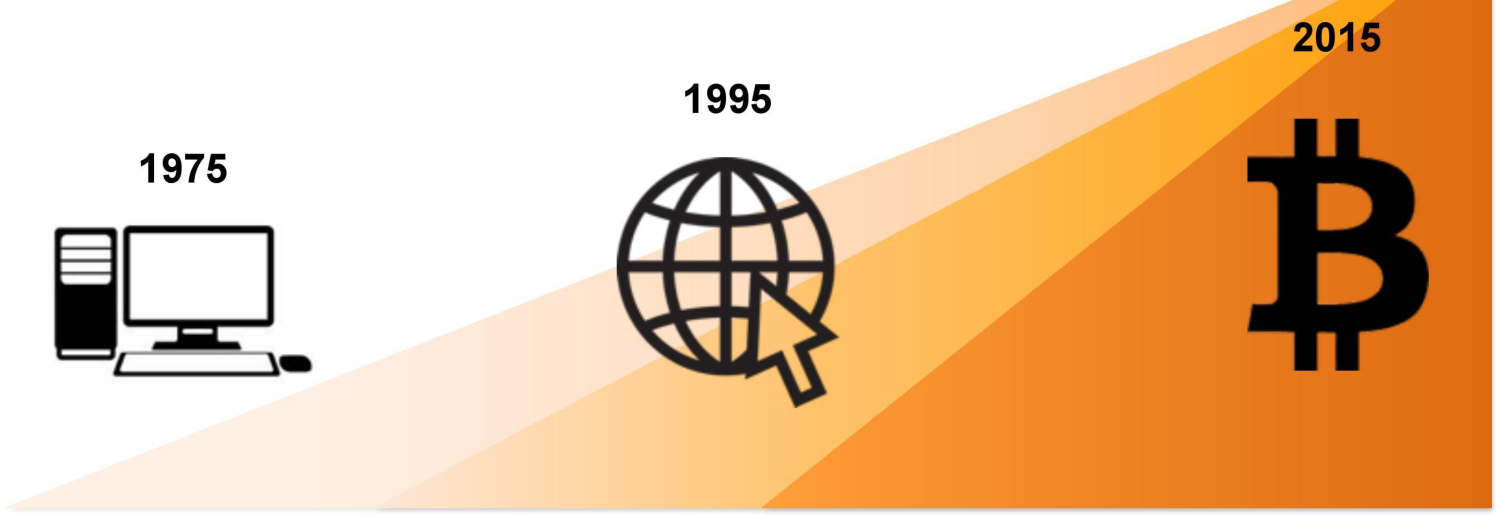
Standard Chartered

"The banking industry is starting to see the many potential benefits of its underlying technology. For banks, the blockchain has the potential to become a technology model for a low-cost and transparent transaction infrastructure." - Anju Patwardhan, Chief Innovation Officer

Royal Bank of Scotland - announced a $3.5 Billion technology revamp over next 3 years

"I don't know what's going to succeed. What I'm certain of is that we are going to see blockchain solutions, peer-to-peer solutions emerging in our industry and we want to be close to that development." - Simon McNamara, Chief Administrative Officer at RBS

THREE TECHNOLOGY EVOLUTIONS OF DISRUPTION



The PC Era
Semiconductor Technology
intel
Microsoft

The Internet Era
TCP/IP Protocol
Google
amazon
facebook
ebay

The Blockchain Era
Bitcoin Protocol
coinbase
itBit
chain
ChangeTip
ripple

EXPERIENCED TEAM IN INVESTING

	BART STEPHENS	BRAD STEPHENS	BROCK PIERCE	PAUL STEPHENS
EXPERIENCE	• Stephens Inv. Mgmt. • Ivanhoe Capital • E*Trade Group • Princeton	• Stephens Inv. Mgmt. • Fidelity Ventures • CSFB • Furman Selz • Duke	• Chairman of the Bitcoin Foundation Board • Founded 15x Startups • Raised > $200M • Invested in > 25x Startups	• Robertson Stephens & Co. • RS Investments • Duke Endowment • UC Berkeley Endowment
RECOGNITION	#2 U.S. Long/Short Hedge Fund* $500 Million AUM 2.5x Venture Fund, 11.5% IRR		Founded 8 crypto currency startups and often referred to as the “father of digital currency”	40 Years in Silicon Valley Investment Management and Banking

Leaders in Technology Investing

Incubated and Founded Dozens of Startups

100’s of Silicon Valley Investments

*Absolute Return Magazine 2004

BROCK PIERCE - CHAIR OF THE BITCOIN FOUNDATION

INDUSTRY LEADER AND SPOKESPERSON

Money 20/20

Milken Institute

Singularity University

WIRED

TNABC

CoinSummit

Inside Bitcoins the future of virtual currency

The Montgomery Summit 2015 Macquarie

SERIAL ENTREPRENEUR

IGE (2001-2007) - **Merged with ItemBay**

Zam (2004-2012) - **Sold to TenCent**

IMI Exchange (2004-Present)

Xfire 2.0 (2011-Present)

Playsino (2011-Present)

GoCoin (payment processor)

Blade Financial (Bitcoin debit card)

Coin Congress (conference)

Repeat Entrepreneur and Digital Currency Visionary

PARTNERS AND ADVISORY BOARD

ALISON DAVIS*	Director: Royal Bank of Scotland, XOOM, Fiserv and First Data
MARY CRANSTON	Director: VISA, ex-CEO and Chair of Pillsbury Winthrop
TERRY SCHWAKOPF	EVP: Federal Reserve Bank of San Francisco, banking supervision
MICHAEL MCADAM	CFO: Union Bank (Mitsubishi UFJ Financial Group)
SIMON MCNAMARA	CTO: RBS, ex-CIO of Standard Chartered, BNP and Deutsche Bank
VINNY LINGHAM	CEO: Gyft (acquired by First Data)
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STEVE BEAUREGARD	CEO: GoCoin
CHRIS PALLOTTA	Special Advisor: MIT Media Lab, Partner: Raptor Capital
MATT OCKO	Partner: Data Collective
WILL O'BRIEN	Co-founder: BitGo
CHARLIE LEE	Coinbase, Founder of Litecoin

* Chairman of the Advisory Board

Built a robust team of Advisors and LPs from the Blockchain ecosystem

CRYPTO CURRENCY PARTNERS I, LP

AUTHY AlphaPoint bex.io BitFury BitGo BitPesa BITACCESS BITCOIN TELLER MACHINE

BLADE BLOCKCYPHER Blockstream BTCC chain ChangeTip

CIRCLE coinbase coinsetter expresscoin freshpay Gem GOCOIN International Payments Platform Koinify

kraken LedgerX NOBLE MARKETS PEERNOVA SFOX snapCard xapo zenBOX zipzap global cash network

The First Dedicated Bitcoin Venture Fund - 30 Investments, Fully Deployed

CRYPTO CURRENCY PARTNERS II, LP

ABRA
BITACCESS BITCOIN TELLER MACHINE
BitGo
Bitnet
BitPesa
Blockstream
BONAFIDE

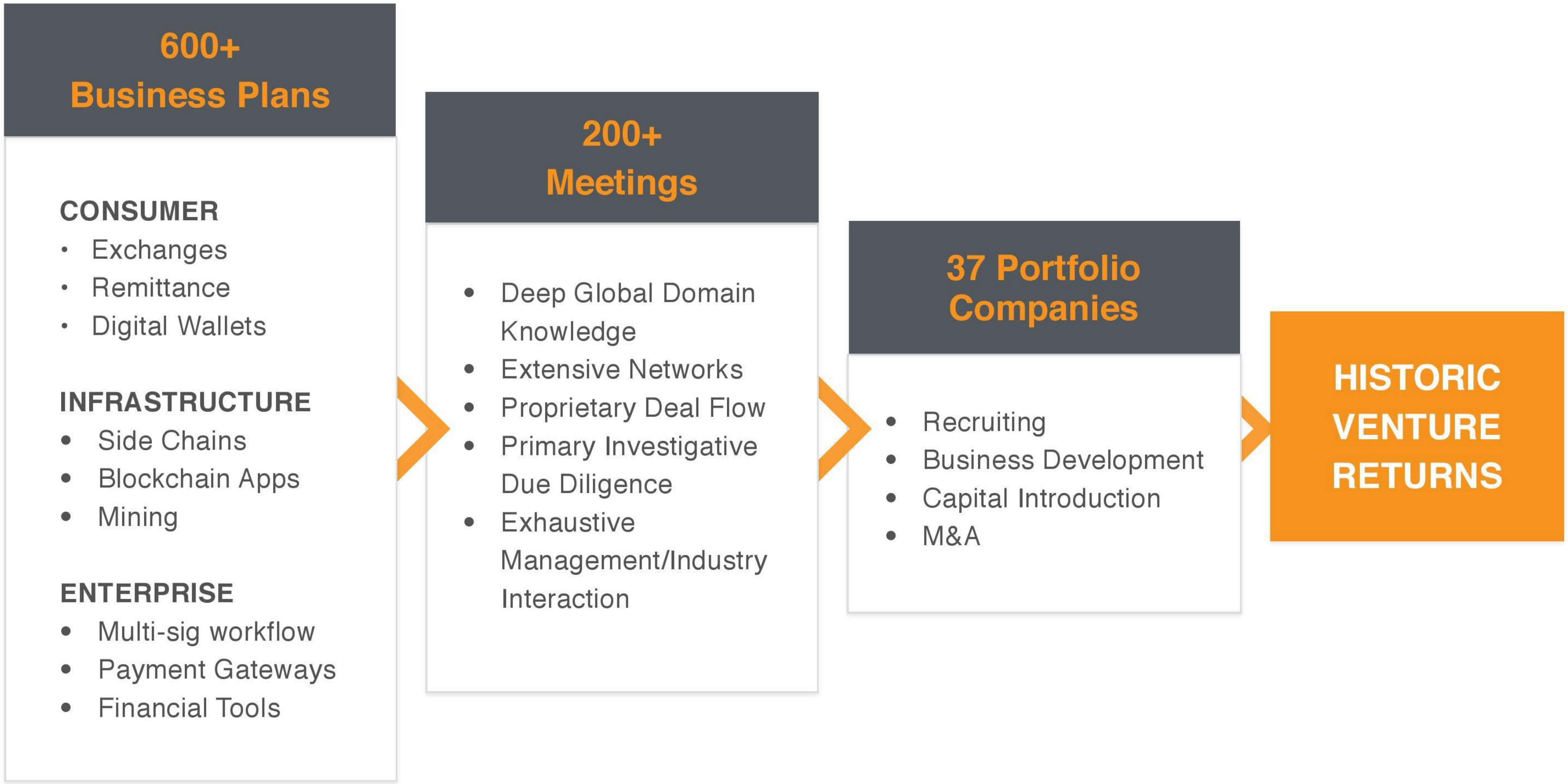
chain
ChangeTip
coinbase
coinsetter
expresscoin
itBit
kraken

Gem
GOCOIN International Payments Platform
LedgerX
PEERNOVA
ripple

Current portfolio - both contributed and new investments

BLOCKCHAIN CAPITAL

PIPELINE & PROCESS



600+
Business Plans

CONSUMER
- Exchanges
- Remittance
- Digital Wallets

INFRASTRUCTURE
- Side Chains
- Blockchain Apps
- Mining

ENTERPRISE
- Multi-sig workflow
- Payment Gateways
- Financial Tools

200+
Meetings

- Deep Global Domain Knowledge
- Extensive Networks
- Proprietary Deal Flow
- Primary Investigative Due Diligence
- Exhaustive Management/Industry Interaction

37 Portfolio Companies

- Recruiting
- Business Development
- Capital Introduction
- M&A

HISTORIC VENTURE RETURNS

ACTIVE BLOCKCHAIN VENTURE INVESTORS

Google ventures · khosla ventures · NEA · BENCHMARK · DFJ · greylock partners.

Redpoint · LIGHTSPEED VENTURE PARTNERS · Foundation CAPITAL · FORTRESS · HIGHLAND CAPITAL PARTNERS

Ribbit Capital · union square ventures · RADAR PARTNERS · ANDREESSEN HOROWITZ · FOUNDERS FUND · PANTERA

IDG · boost · PLUGANDPLAY Silicon Valley in a Box · RRE Ventures · Y Combinator · First Round CAPITAL

Blockchain Capital has co-invested with these leading VCs

CCP II - 8 CONTRIBUTED INVESTMENTS

	DATE INVESTED	$ AMOUNT	DETAILS
BitGo	June '14	$75,000	Series A preferred
Coinsetter	December '13	$50,000	Converted to Series A at 1.5x
expresscoin	November '13	$25,000	Convert to Series A, $2.5m Cap
GoCoin	October '13	$100,000	Converted to Series A at 4.5x
Kraken	April '14	$70,000	Series A preferred
LedgerX	July '14	$50,000	Series A preferred
BitAccess	September '14	$25,000	Note discounted to Series A preferred
BitNet	October '14	$75,000	Series A Preferred
TOTAL		**$470,000**	**(current value ~ $815,000… 1.7x)**

General Partners contributed co-investments **at cost** to CCP II

CCP II - 12 NEW INVESTMENTS MADE

	DATE INVESTED	$ AMOUNT	DETAILS
PeerNova	September '14	$50,000	Converted to Series A preferred
BlockStream	October'14	$100,000	Series A preferred
ChangeTip	November '14	$250,000	Series A preferred
Bonafide	November'14	$50,000	Note discounted to Series A preferred
BitPesa	December '14	$100,000	Note discounted to Series A preferred
Coinbase	December '14	$200,000	Series C preferred
itBit	January '15	$250,000	Series B preferred
Ripple	March '15	$250,000	Series A preferred
ABRA	July '15	$100,000	Series A preferred
Stem	August '15	$250,000	Note discounted to Series A preferred
Chain	September '15	$250,000	Series C preferred
Gem	September '15	$250,000	Series A preferred
	TOTAL	**$2,100,000**	

CCP II - STRATEGY AND MAKE-UP

EXPOSURE	Diversified Sector-specific
FUND POSITION ALLOCATION	**50%** New CCP II investments **30%** Reserves for CCP II follow-on rounds **20%** Option to use CCP I's follow-on rights
INVESTMENT STRATEGY	Leverage our network and industry expertise to find investments that utilize Blockchain technologies and help these portfolio companies disrupt legacy industries.

Access to CCP's early seed deals as well as future deals

CCP II - SUMMARY OF TERMS

FUND TARGET	$10-15M
TERM	6-8 Years
FEE/INCENTIVE	2.5% / 25%
GP CONTRIBUTION	+5% Fund or +$1m
INVESTMENTS	25 ($100k - $500k per deal)
STRUCTURE	4 x 25% capital calls, BTC Accepted

CCP II - SERVICE PROVIDERS

ADMINISTRATION / CFO	Kranz & Associates
LEGAL	Sidley Austin
TAX / AUDIT	Crawford Pimintel
BANK	Silicon Valley Bank
CUSTODIAN	Merrill Lynch
BTC VAULT	Xapo & BitGo

USE CASES FOR BLOCKCHAIN TECHNOLOGY

Financial and Records

Bitcoin Private Equities Bonds Public Equities
Shareholder Voting Remittance Crowd-funding
Spending Records Micro-payments Commodities
Trading Records Derivatives Mortgage/loan records
Digital Coupons Servicing records Micro-charity

Legal / Health / Education

Smart Contracts Signatures/identity Degrees
Wills Genome data Trusts Licensing
Medical Records Escrows Delivery records
Arbitration Grades Patents Copyrights
Certifications Academic Credits

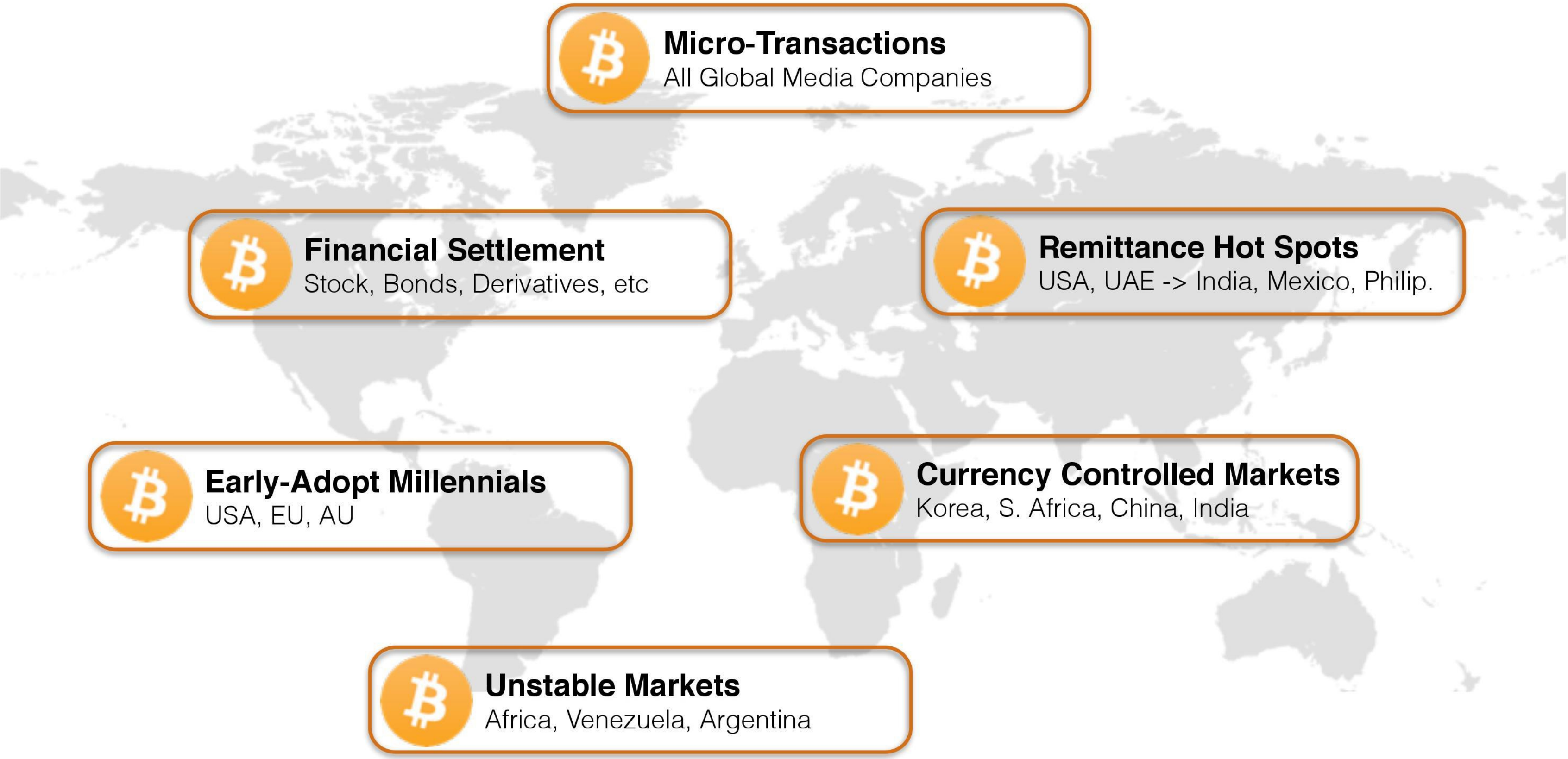
Public Records

Land titles Birth certificates Vehicle registries
Business license Business Incorporation/dissolution
Business Ownership records Regulatory records
Criminal records Passports Death certificates
Voter IDs Building permits Health/safety inspections
Non-profit records Court records Gun permits Voting

Commercial / Media

HR Records Supply chain mgmt Accounting records
Business transaction records Software licenses
Trademarks Spam Filters Hotel room keys
Global trade network Loyalty Points Vouchers
Domain names Betting records Movie Tickets
DRM: Music/movie/book license GPS network identity

OPPORTUNITES FOR BLOCKCHAIN ADOPTION



Micro-Transactions
All Global Media Companies

Financial Settlement
Stock, Bonds, Derivatives, etc

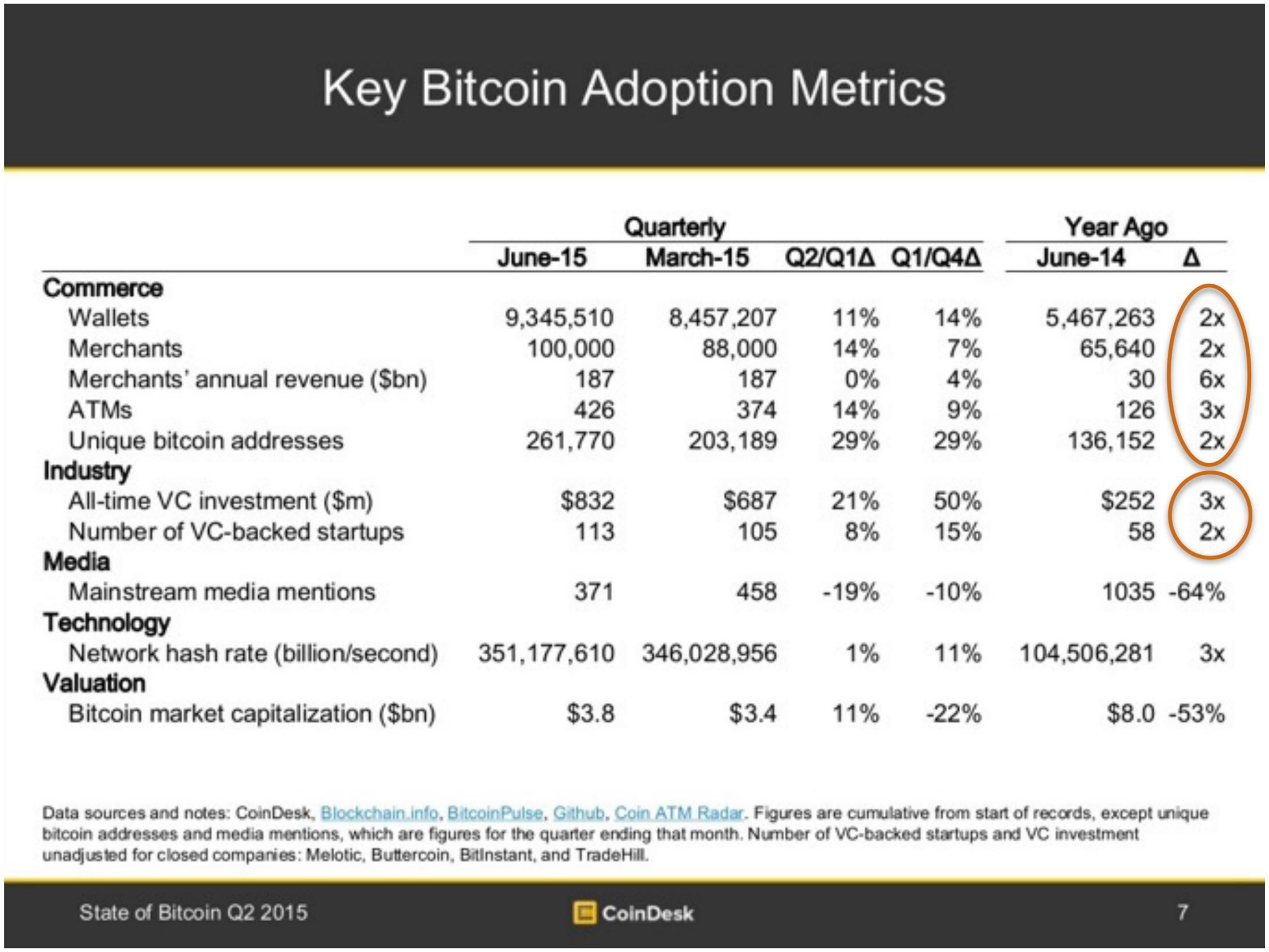
Remittance Hot Spots
USA, UAE -> India, Mexico, Philip.

Early-Adopt Millennials
USA, EU, AU

Currency Controlled Markets
Korea, S. Africa, China, India

Unstable Markets
Africa, Venezuela, Argentina

INDUSTRY GROWTH: 2014 to 2015



Key Bitcoin Adoption Metrics

	Quarterly				Year Ago	
	June-15	March-15	Q2/Q1Δ	Q1/Q4Δ	June-14	Δ
Commerce						
Wallets	9,345,510	8,457,207	11%	14%	5,467,263	2x
Merchants	100,000	88,000	14%	7%	65,640	2x
Merchants' annual revenue ($bn)	187	187	0%	4%	30	6x
ATMs	426	374	14%	9%	126	3x
Unique bitcoin addresses	261,770	203,189	29%	29%	136,152	2x
Industry						
All-time VC investment ($m)	$832	$687	21%	50%	$252	3x
Number of VC-backed startups	113	105	8%	15%	58	2x
Media						
Mainstream media mentions	371	458	-19%	-10%	1035	-64%
Technology						
Network hash rate (billion/second)	351,177,610	346,028,956	1%	11%	104,506,281	3x
Valuation						
Bitcoin market capitalization ($bn)	$3.8	$3.4	11%	-22%	$8.0	-53%

Data sources and notes: CoinDesk, Blockchain.info, BitcoinPulse, Github, Coin ATM Radar. Figures are cumulative from start of records, except unique bitcoin addresses and media mentions, which are figures for the quarter ending that month. Number of VC-backed startups and VC investment unadjusted for closed companies: Melotic, Buttercoin, BitInstant, and TradeHill.

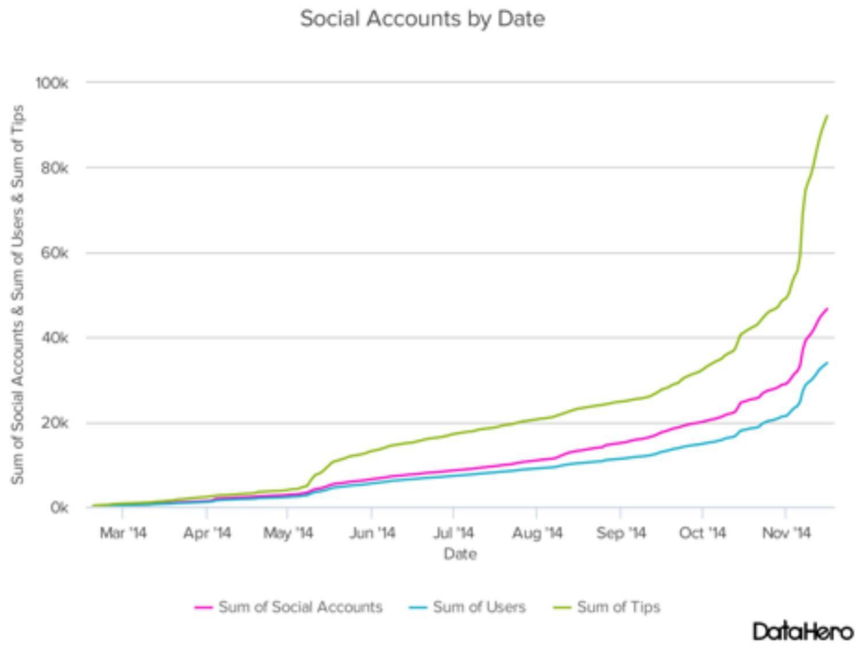
State of Bitcoin Q2 2015 CoinDesk 7

CASE STUDY: ChangeTip

ChangeTip enables a “tipping” feature using Bitcoin on other companies’ websites. It has built a Bitcoin micropayment platform that is currently integrated with Twitter, GitHub, Reddit, Google+, Tumblr, and YouTube.

We believe that ChangeTip’s micro transaction platform is poised to be the financial equivalent of the “Like” button, and enabling new mechanisms for premium online constant to be monetized.

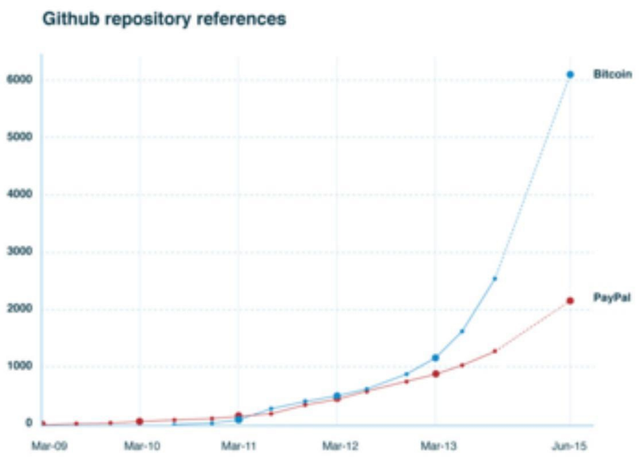
ChangeTip


Social Accounts by Date

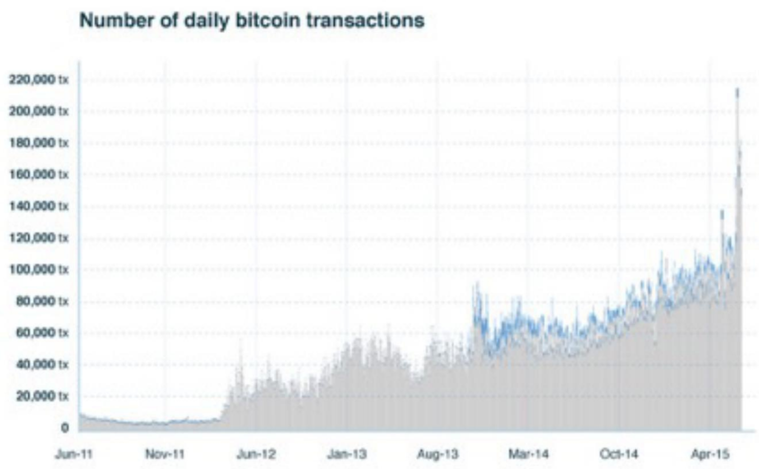
BLOCKCHAIN CAPITAL

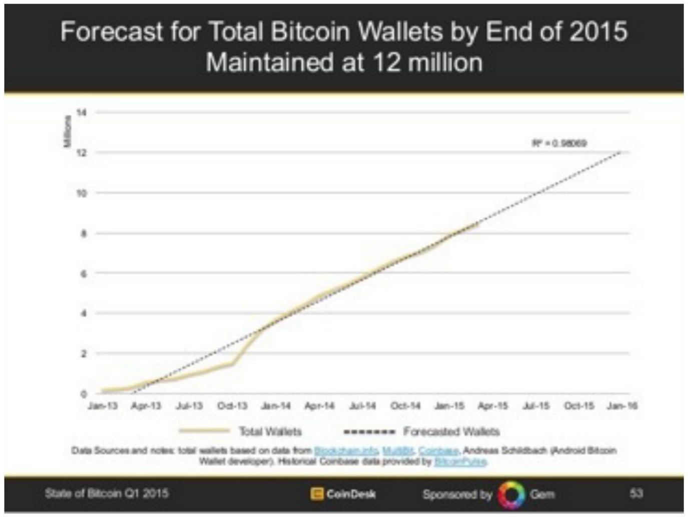
HYPER-GROWTH- 2013 to 2015

Github repository references



Number of daily bitcoin transactions

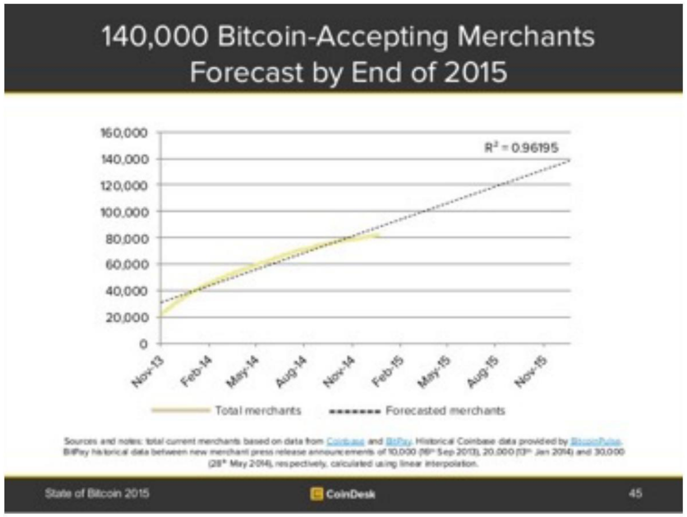




Forecast for Total Bitcoin Wallets by End of 2015
Maintained at 12 million

Data Sources and notes: total wallets based on data from Blockchain.info, MultiBit, Coinbase, Andreas Schildbach (Android Bitcoin Wallet developer). Historical Coinbase data provided by BitcoinPulse.

State of Bitcoin Q1 2015 CoinDesk Sponsored by Gem 53



140,000 Bitcoin-Accepting Merchants
Forecast by End of 2015

Sources and notes: total current merchants based on data from Coinbase and BitPay. Historical Coinbase data provided by BitcoinPulse. BitPay historical data between new merchant press release announcements of 10,000 (16th Sep 2013), 20,000 (13th Jan 2014) and 30,000 (28th May 2014), respectively, calculated using linear interpolation.

State of Bitcoin 2015 CoinDesk 45

SUMMARY

BLOCKCHAIN
CAPITAL

FIRST DEDICATED BITCOIN VENTURE FUND

UNPARALLELED ACCESS TO DEAL-FLOW

PROVEN TRACK RECORDS

Building the Future Leaders in the Blockchain Economy

VOTE STACEY PLASKETT
FOR CONGRESS 2016
UNITED STATES VIRGIN ISLANDS

FIRST TERM ACCOMPLISHMENTS 2015-2016

- Named to the Committees on Agriculture and Oversight and Government Reform
- Named as the Freshman representative on the Democratic Leadership Steering and Policy Committee
- Named by Southern Region as Regional Whip for Democrats
- Named to Leader Nancy Pelosi's Future Forum Group. Made up of a select group of 10 Members of Democratic Conference to engage millennials in political process
- Selected to President Obama's White House Renewable Energy roundtable group
- Led the Virgin Islands' delegation to the First Caribbean Energy Security Summit in DC

Successful Legislative Activity

- Successfully removed the Virgin Islands and small territories from PROMESA (Puerto Rico Oversight Management Economic Security Act), which threatened VI municipal credit and borrowing ability along with self-governance
- Secured VA decision to expand Choice Program eligibility for Virgin Islands resident veterans
- Original Co-Sponsor of legislation to expand the VA choice program eligibility (H.R.572)
- Secured House passage of the Virgin Islands of the United States Centennial Commission Act (H.R.2615)
- Successfully worked to repeal the DC Budget proposal listing USVI and other Caribbean islands as tax havens which would have negatively affected our ability to secure banking and Treasury support
- Led the defeat of an amendment to the transportation authorization bill (Territorial Highway Program: H.R.2353) that would have reduced federal dollars for the Virgin Islands
- Defeated attempt by American Samoa and Northern Mariana to reallocate percentage of funding going to the USVI for other small territories
- Secured Commitment from Army Corp of Engineers for increased personnel and resources for Virgin Islands backlog of permits
- One of a small group of Members of Congress to be involved in the planning of the unprecedented "sit-in" of House Democrats for action to address American gun violence
- Secured Agriculture drought relief assistance for farmers and livestock owners and commitment to keep data on territories for future assistance and to designate St. Croix a primary disaster area due to severe drought
- Honored by global food and poverty groups for being a leading voice on issues affecting food and nutrition security

Major Sponsored Legislation

- Virgin Islands Visa Waiver Act of 2015 (H.R. 2116) — Gives expedited visa process for members of the Caribbean Community (CARICOM) to enter the USVI for sports, entertainment, medical, and recreational purposes.
- Hire-A-Hero Act of 2015 (H.R.2457) — Gives tax credits to small businesses that hire someone in the Reserves or National Guard.
- United States Virgin Islands College Access Act of 2015 (H.R. 4191) — Allows student who are residents of the VI to receive in-state tuition when applying to participating state universities.
- Lobbied Obama Administration to include UVI as a community college for the President's proposal to make 2 years free at community colleges.
- Territorial Economic Growth and Recovery Act of 2016 (H.R.5163) — Introduced to amend the Internal Revenue Code of 1986 to provide for economic recovery in the Virgin Islands and Guam, and for other purposes.
- Territorial Tax Equity and Economic Growth Act (H.R.5038) — Introduced to amend the Internal Revenue Code of 1986 to provide for economic recovery in the territories.
- Co-Sponsored legislation to extend SSI benefits to the U.S. Virgin Islands (H.R.582)
- Visited Dominica immediately after Hurricane Erika and hosted Dominican Ambassador in Congress. Introduced H.Res.453 with numerous co-sponsors for additional Dominican assistance

Field Activities

- Sponsored workshops on STT and STX for small businesses on federal contracting
- Partnered with USDA for workshops (STX and STT) on technical support for Farmers
- Had several town halls on St. Croix, St. Thomas, and St. John.
- Commitment to visit ALL schools in the Virgin Islands, and currently have visited over 15 schools. Will continue to meet with heads of school, teachers AND students.
- Organized and hosted first ever official roundtable discussion between VI Delegate to Congress and Virgin Islands Legislature
- Organized annual "VI Advocacy Day" in Congress, focused on elevating VI issues via local business owners and advocates
- Held meetings with various Regional Directors of agencies to discuss issues/concerns affecting the VI including:
    - HIDTA (High Intensity Drug Trafficking Agency)
    - Customs and Border Protection
    - U.S. Postal Service
    - USPS letter carriers
    - HUD (Housing and Urban Development)
    - VA Regional Hospital in Puerto Rico

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From: Quora Digest [digest-noreply@quora.com]
Sent: 7/7/2019 7:03:04 PM
To: jeevacation@gmail.com
Subject: What is the French paradox?

Jeffrey's Digest

TOP STORIES FOR YOU

What is the French paradox?

Olga Persson, knows French
Written Jun 26

People refer to French paradox when they are talking about the puzzling phenomenon of French people getting away with murder vis-a-vis food and drink. Unapologetic love for...

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What’s the legality of living on a boat (any size) off the coast in the U.S.?

Jeanne Pockel, 28 years full-time blue water sailing/cruising, 50 countries
Written Jun 24

Have you noticed that you don’t see many boats anchored off the shore of ocean beaches? And rarely if ever overnight? That boats anchor in harbors, bay, rivers, but not off...

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If x^2 + 16 = 0, then what is x?

Dave Clark, studied Mathematics at Queens' College, Cambridge
Written Nov 15, 2018

[math]x^2 + 16 = 0[/math]

[math]\therefore x^2 = -16[/math]

[math]\therefore x = \pm \sqrt{-16}[/math]

Negative numbers have no square roots in the real numbers, so if you are looking for real values only then there are no solutions. If we are looking for complex values too ...

Read More »

As a flight attendant, what is the most disrespectful thing a passenger has ever requested from you?

Susan Brown, Flight Attendant
Updated Jan 2

I once had a strange passenger that asked me to go and check the ‘’toilet” for her, before she went in.

I asked her why she wanted me to check the lavatory FOR HER. She tol...

Read More »

Updated May 23

1. His house is worth $650,000
2. He flies by private jet
3. His California vacation home is worth $11,000,000
4. He drives a Cadillac...

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What indeed happens when you drop the soap in jail?

Paul Passmore, Activist in the black community
Written Jun 30

Usually, you have to yell really loudly to one of your friends or bunkmate and tell him to bring you another bar of soap. And that invites everyone within earshot to laugh ...

Read More »

Do you think it's inappropriate for John Oliver to call President Donald Trump an "Uncooperative Toddler"?

James Elefante
Written Jun 24

What’s that my mother used to say about “if you can’t stand the heat then get out of the kitchen.” He we have THE PRESIDENT of the United States giving childish and bullish...

Read More »

What do they say in French at a restaurant when asking the customers “for here or to go?”

Cathelène Dechesne, knows French
Updated Jun 24

Hello! I’m French, and I would love to answer this question for you :)

In France, when ordering a meal at a restaurant, if the waiter/waitress asks a customer “for here or t...

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Bannon joins a growing list of political figures associated with President Trump who have been confronted in public in recent weeks.

Protesters in Kentucky followed Senate Majority Leader Mitch McConnell (R-Ky.) to his car while he was leaving a Louisville restaurant on Saturday, threatening to vote him out of office.

Others, including White House press secretary Sarah Huckabee Sanders and Department of Homeland Security Secretary Kirstjen Nielsen, also have been confronted by protesters for their association with the Trump administration and its policies.

Richard Kahn
HBRK Associates Inc.
575 Lexington Avenue, 4th Floor
New York, NY 10022
[redacted]

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CARVANA CO.

FORM DEF 14A

(Proxy Statement (definitive))

Filed 03/14/19 for the Period Ending 04/23/19

Address	1930 W. RIO SALADO PARKWAY TEMPE, AZ, 85281
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Symbol	CVNA
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Industry	Auto Vehicles, Parts & Service Retailers
Sector	Consumer Cyclicals
Fiscal Year	12/31

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

SCHEDULE 14A INFORMATION

Proxy Statement Pursuant to Section 14(a) of the Securities Exchange Act of 1934

Filed by the Registrant ☒ Filed by a Party other than the Registrant ☐

Check the appropriate box:

☐ Preliminary Proxy Statement

☐ **Confidential, for Use of the Commission Only (as permitted by Rule 14a-6(e)(2))**

☒ Definitive Proxy Statement

☐ Definitive Additional Materials

☐ Soliciting Material Pursuant to §240.14a-12

CARVANA CO.

(Name of registrant as specified in its charter)

(Name of Person(s) Filing Proxy Statement, if other than the Registrant)

Payment of Filing Fee (Check the appropriate box):

☒ No fee required.

☐ Fee computed on table below per Exchange Act Rules 14a-6(i)(1) and 0-11.

(1) Title of each class of securities to which transaction applies:

(2) Aggregate number of securities to which transaction applies:

(3) Per unit price or other underlying value of transaction computed pursuant to Exchange Act Rule 0-11 (Set forth the amount on which the filing fee is calculated and state how it is determined):

(4) Proposed maximum aggregate value of transaction:

(5) Total fee paid:

☐ Fee paid previously with preliminary materials.

☐ Check box if any part of the fee is offset as provided by Exchange Act Rule 0-11(a)(2) and identify the filing for which the offsetting fee was paid previously. Identify the previous filing by registration statement number, or the form or schedule and the date of its filing.

(1) Amount Previously Paid:

(2) Form, Schedule or Registration Statement No.:

(3) Filing Party:

(4) Date Filed:

Dear Fellow Stockholders,

We are pleased to invite you to attend the Annual Meeting of Stockholders of Carvana Co.

Date : Tuesday, April 23, 2019
Time : 8 AM (PDT)
Address : 3419 East University Drive
Phoenix, AZ 85034

You can access our proxy materials online at www.proxydocs.com/CVNA. We will mail a notice containing instructions on how to access this proxy statement and our annual report on or about Thursday, March 14, 2019, to all stockholders entitled to vote at the annual meeting. Stockholders who prefer a paper copy of the proxy materials may request one on or before April 12, 2019, by following the instructions provided in the notice we will send.

Your vote is important. Whether or not you plan to attend the annual meeting, we urge you to vote. You may vote by proxy over the internet, by telephone, or by mail by following the instructions on the proxy card. Voting by proxy will ensure your representation at the annual meeting regardless of whether you attend.

Sincerely,

Ernest Garcia III

President, Chief Executive Officer and Chairman

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COMMONLY ASKED QUESTIONS AND ANSWERS ABOUT THE ANNUAL MEETING

Q: Why did I receive these materials?

The Board of Directors of Carvana Co. is soliciting your proxy to vote at our 2019 Annual Meeting of Stockholders (or at any postponement or adjournment of the meeting). Stockholders who own shares of our common stock (Class A or Class B) as of the record date, February 25, 2019, are entitled to vote at the annual meeting. You should review these proxy materials carefully as they give important information about the items that will be voted on at the annual meeting, as well as other important information about Carvana.

Q: Who will be entitled to vote?

Stockholders who own shares of our common stock as of the record date, February 25, 2019, are entitled to vote at the annual meeting. As of the record date, Carvana had approximately 41,201,324 shares of Class A common stock outstanding and 104,336,303 shares of Class B common stock outstanding. Holders of shares of Class A common stock are entitled to one vote per share of Class A common stock. Ernest Garcia II, Ernest Garcia III, and entities controlled by one or both of them (collectively, the “Garcia Parties”) are entitled to ten votes per share of Class B common stock they beneficially own, for so long as the Garcia Parties maintain, in the aggregate, direct or indirect beneficial ownership of at least 25% of the outstanding shares of Class A common stock, determined on an as-exchanged basis assuming that all of the Class A common units (“Class A Units”) and Class B common units (“Class B Units,” and together with Class A Units, “LLC Units”) of Carvana Group, LLC (“Carvana Group”) were exchanged for Class A common stock. The Garcia Parties are currently entitled to ten votes per share of Class B common stock they beneficially own. All other holders of Class B common stock are entitled to one vote per share. All holders of Class A common stock and Class B common stock will vote together as a single class except as otherwise required by applicable law. Cumulative voting is not permitted with respect to the election of directors or any other matter to be considered at the annual meeting.

Q: What will I be voting on?

You will be voting on the following matters:

1. to elect two Class II directors to serve on Carvana’s board of directors until the 2022 Annual Meeting and until their successors are duly elected and qualified;
2. to ratify the appointment of Grant Thornton LLP as Carvana’s independent registered public accounting firm for the year ending December 31, 2019;
3. to consider the approval, by an advisory vote, of Carvana’s executive compensation (i.e., “say-on-pay”);

4. to recommend, by an advisory vote, the frequency of future advisory votes on executive compensation (i.e., "say-on-pay frequency"); and
5. to transact other business as may properly come before the meeting or any adjournment of the meeting.

Q: How does the board recommend I vote on these matters?

The board of directors recommends you vote for the following:

1. FOR the election of Gregory Sullivan and Dan Quayle as Class II directors;
2. FOR the ratification of the appointment of Grant Thornton LLP as our independent registered public accounting firm for the year ending December 31, 2019;
3. FOR the approval, by an advisory vote, of Carvana's executive compensation; and
4. FOR an advisory vote that future advisory votes on executive compensation occur annually.

Q: How do I cast my vote?

Beneficial Stockholders . If you hold your shares through a broker, trustee, or other nominee, you are a beneficial stockholder. To vote your shares, please refer to the materials forwarded to you by your broker, bank, or other nominee for instructions on how to vote the shares you hold as a beneficial stockholder.

Registered Stockholders . If you hold shares in your own name, you are a registered stockholder and may vote by written ballot at the annual meeting or by proxy before the annual meeting in the following ways:

1. online at www.proxypush.com/CVNA;
2. by phone by calling (866) 509-2149; or
3. by signing and returning a proxy card.

Proxies submitted online or by telephone must be received before 8:00 AM (PDT) on April 23, 2019.

Q: Can I access the proxy materials electronically?

Yes. Your notice, proxy card, or voting instruction card will contain instructions on how to view our proxy materials for the annual meeting online and how to instruct us to send our future proxy materials to you electronically by email. Our proxy materials are also available at www.proxypush.com/CVNA and will be available during the voting period starting on March 14, 2019.

Instead of receiving future copies of our proxy statement and annual reports by mail, stockholders of record and most beneficial owners can elect to receive an email that will provide an electronic link to these documents. Your election to receive future proxy materials by email will remain in effect until you revoke it.

Please note that only one notice will be sent to stockholders who are listed at the same address.

Q: How may I change or revoke my proxy?

Beneficial Stockholders . Beneficial stockholders should contact their broker, trustee, or nominee for instructions on how to change their proxy vote.

Registered Stockholders . Registered stockholders may change a properly executed proxy at any time before its exercise by

1. delivering written notice of revocation to the general counsel and secretary at our principal executive offices at 1930 W. Rio Salado Pkwy, Tempe, AZ 85281;
2. submitting another proxy that is dated later than the original proxy (including a proxy via telephone or internet); or
3. voting in person at the annual meeting.

Q: Who can attend the annual meeting?

Subject to space availability, all common stockholders as of the record date, or their duly appointed proxies, may attend the annual meeting. Since seating is limited, admission to the annual meeting will be on a first-come, first-served basis. Registration will begin at 7:30 AM (PDT). If you attend, please note that you may be asked to present valid photo identification, such as a driver's license or passport.

Please also note that if you are a beneficial stockholder (that is, you hold your shares through a broker, bank or other nominee), you will need to bring a copy of a brokerage statement reflecting your stock ownership as of the record date and check in at the registration desk at the annual meeting.

Cameras, recording devices and other electronic devices will not be permitted at the annual meeting.

Q: What is the voting requirement to approve each of the items, and how are the votes counted?

ITEM 1 – ELECTION OF DIRECTORS . A plurality of the votes cast by the shares of common stock present in person or represented by proxy at the meeting and entitled to vote thereon is required to elect each nominee. This means that the two nominees receiving the highest number of votes at the annual meeting will be elected, even if those votes do not constitute a majority of the votes cast. Abstentions and broker non-votes will not impact the election of the nominees.

ALL OTHER ITEMS . The affirmative vote of a majority of the votes cast by the shares of common stock present in person or represented by proxy at the meeting and entitled to vote thereon is required to approve all other items. Abstentions will be counted as present and entitled to vote on the proposal and will therefore have the effect of a negative vote. We do not expect there to be any broker non-votes with respect to any of the proposals.

Q: When will the results of the vote be announced?

The preliminary voting results will be announced at the annual meeting. The final voting results will be published in a current report on Form 8-K filed with the SEC within four business days of the annual meeting.

Q: What is the deadline for submitting a stockholder proposal or director nomination for the 2020 Annual Meeting?

Stockholder proposals pursuant to SEC Rule 14a-8 for inclusion in Carvana’s proxy statement and form of proxy for Carvana’s 2020 Annual Meeting of Stockholders must be received by Carvana at our principal executive offices at 1930 W. Rio Salado Pkwy, Tempe, AZ, 85281, no later than the close of business on November 15, 2019. Stockholders wishing to make a director nomination or bring a proposal, but not include it in Carvana’s proxy materials, must provide written notice of their nomination or proposal to the general counsel and secretary at Carvana’s principal executive offices no later than the close of business on January 24, 2020, and not earlier than the close of business on December 25, 2019, assuming Carvana does not change the date of the 2020 Annual Meeting of Stockholders by more than 30 days before or after the anniversary of the 2019 Annual Meeting. If so, Carvana will release an updated time frame for stockholder proposals. Any stockholder proposal or director nomination must comply with the other provisions of Carvana’s amended and restated bylaws and be submitted in writing to the general counsel and secretary at Carvana’s principal executive offices.

BOARD OF DIRECTORS AND CORPORATE GOVERNANCE

Our business and affairs are managed under the direction of our Board, which is composed of five directors. Our certificate of incorporation provides that the authorized number of directors may be changed only by resolution of our Board. Our certificate also provides that our Board will be divided into three classes of directors, with the classes as nearly equal in number as possible. At each annual meeting of stockholders, a class of directors will be elected for a three-year term to succeed the class whose term is then expiring.

The following table sets forth the director class, name, age as of April 23, 2019, and other information for each member of our board of directors:

NAME	CLASS	AGE	POSITION	DIRECTOR SINCE	CURRENT TERM EXPIRES	EXPIRATION OF TERM FOR WHICH NOMINATED
Gregory Sullivan	II	60	Director	2017	2019	2022
Dan Quayle	II	72	Director	2017	2019	2022
Michael Maroone	III	65	Lead Director	2017	2020	
Ernest Garcia III	I	36	President, CEO and Chairman	2017	2021	
Ira Platt	I	55	Director	2017	2021	

We believe that in order for our Board to effectively guide us to long-term sustainable, dependable performance, it should be composed of individuals with sophistication and experience in the many disciplines that impact our business. To best serve our stockholders, we seek to have a board that, as a whole, is competent in key corporate disciplines, including accounting and financial acumen, business judgment, crisis management, governance, leadership, people management, risk management, social responsibility and reputational issues, and strategy and strategic planning. Additionally, the Board desires to have specific knowledge related to our industry, such as expertise in automotive retail and consumer finance.

The Compensation and Nominating Committee believes that all directors must, at a minimum, meet the criteria set forth in the Board's code of conduct and the corporate governance guidelines, which specify, among other things, that the Compensation and Nominating Committee will consider criteria such as independence, diversity, age, skills, and experience in the context of the needs of the Board. In addressing issues of diversity in particular, the Compensation and Nominating Committee considers a nominee's differences in viewpoint, professional experience, background, education, skill, age, race, gender, and national origin. The Compensation and Nominating Committee believes that diversity of backgrounds and viewpoints is a key attribute for a director nominee. Accordingly, to improve director diversity and best serve our stockholders, the Compensation and Nominating Committee adopted a policy in 2019 to request that any search firm that it engages include women and minority candidates in the initial list from which the committee selects director candidates. The Compensation and Nominating Committee also will consider a combination of factors for each director, including whether the nominee possesses:

- the ability to represent all stockholders without a conflict of interest;
- the ability to work in and promote a productive environment;
- sufficient time and willingness to fulfill the substantial duties and responsibilities of a director;
- the high level of character and integrity that we expect;
- broad professional and leadership experience and skills necessary to effectively respond to the complex issues encountered by a national, publicly traded company; and
- the ability to apply sound and independent business judgment.

The Compensation and Nominating Committee has determined that all of our directors meet the criteria and qualifications set forth in the code of conduct for the Board of Directors, the corporate governance guidelines and the criteria set forth above for director nominees. Moreover, each director possesses the following critical personal qualities and attributes that we believe are essential for the proper functioning of the Board to allow it to fulfill its duties for our stockholders: accountability, ethical leadership, governance, integrity, risk management, and sound business judgment. In addition, our directors have the mature confidence to assess and challenge the way things are done and recommend alternative solutions, a keen awareness of our business and the social realities of the environment in which we operate, the independence and high-performance standards necessary to fulfill the Board's oversight function, and the humility, professional maturity, and style to interface openly and constructively with other directors. Finally, the director biographies below include a non-exclusive list of other key experiences and qualifications that further qualify the individual to serve on the Board. These collective qualities, skills, experiences, and attributes are essential to our Board's ability to exercise its oversight function for Carvana and its stockholders and to guide the long-term sustainable, dependable performance of our business.

Subject to any earlier resignation or removal in accordance with the terms of our certificate and bylaws, our Class II directors will serve until this our second annual meeting of stockholders, our Class III directors will serve until the third annual meeting of stockholders, and our Class I directors will serve until our fourth annual meeting of stockholders. In addition, our certificate provides that our directors may be removed with or without cause by the affirmative vote of at least a majority of the voting power of our outstanding shares of stock entitled to vote thereon, voting together as a single class, for so long as the Garcia Parties are entitled to ten votes for each share of Class B common stock they hold. If the Garcia Parties are no longer entitled to ten votes for each share of Class B common stock they hold, then our directors may be removed only for cause upon the affirmative vote of at least 66 $^{2}/_{3}$ % of the voting power of our outstanding shares of stock entitled to vote thereon.

The Compensation and Nominating Committee will consider stockholder nominations for membership on the Board. For the 2020 Annual Meeting, nominations may be submitted to Carvana Co., 1930 W. Rio Salado Pkwy, Tempe, AZ 85281, Attn: Secretary, who will forward them to the Chairman of the Compensation and Nominating Committee. Recommendations must be in writing and we must receive the recommendation no later than the close of business on January 24, 2020, and not earlier than the close of business on December 25, 2019. Recommendations must also include certain other requirements specified in our bylaws. The committee will apply the same criteria to the evaluation of those candidates as it applies to other director candidates.

When filling a vacancy on the Board, the Compensation and Nominating Committee identifies the desired skills and experience of a new director and nominates individuals who it believes can strengthen the Board's capabilities and further diversify the collective experience represented by the then-current directors. The Compensation and Nominating Committee may engage third parties to assist in the search and provide recommendations. Pursuant to a previously informal policy formally adopted in 2019, any search firm that the committee engages is requested to include women and minority candidates in the initial list from which the committee selects director candidates. Also, directors are generally asked to recommend candidates for the position. The candidates would be evaluated based on the process outlined in the Corporate Governance Guidelines and the Compensation and Nominating Committee charter, and the same process would be used for all candidates, including candidates recommended by stockholders.

ITEM 1—ELECTION OF DIRECTORS

Our Board recommends that the nominees below be elected as members of the Board at the annual meeting to serve for a three-year term expiring at the 2022 Annual Meeting.

NAME	AGE	DIRECTOR SINCE	POSITION
Gregory Sullivan	60	2017	Director
Dan Quayle	72	2017	Director

Each nominee was recommended for re-election by the Compensation and Nominating Committee for consideration by the Board and proposal to our stockholders. If, before the annual meeting, any nominee becomes unable to serve, or chooses not to serve, the Board may (i) nominate a substitute (ii) allow the vacancy to remain until the Board identifies an appropriate candidate or (iii) reduce the size of the board to eliminate the vacancy. If the Board chooses to nominate a substitute nominee, the persons named as proxies on the proxy card will vote for that substitute nominee.

The Board of Directors recommends that you vote "FOR" each of the director nominees.

DIRECTOR NOMINEES

Dan Quayle has served on our Board since the completion of our initial public offering ("IPO") in 2017. Mr. Quayle has served the United States Federal Government in various capacities: congressman, senator, and as the 44th vice president of the United States of America from 1989 to 1993. Since 1999, Mr. Quayle has been with Cerberus Capital, a New York private investment firm. He has served as chairman of Cerberus Global Investments since 2001. Mr. Quayle earned a B.A. degree in political science from DePauw University and a J.D. from the Indiana University Robert H. McKinney School of Law. We believe Mr. Quayle is qualified to continue to serve on our Board because of his experience as the chairman of Cerberus Global Investments, LLC, as well as his extensive experience in the areas of government, foreign relations, and private investment.

Gregory Sullivan has served on our Board since the completion of our IPO. Mr. Sullivan is the co-founder and chief executive officer of AFAR Media, a travel media company he co-founded in 2007. From 1995 to 2007, Mr. Sullivan served the DriveTime Automotive Group, Inc. ("DriveTime") in various capacities, including as president from 1995 to 2004, chief executive officer from 1999 to 2004, and vice chairman from 2004 to 2007. Mr. Sullivan earned a B.B.A. degree in finance from the University of Notre Dame and a J.D. from the University of Virginia School of Law. We believe that Mr. Sullivan is qualified to continue to serve on our Board because of his senior management experience in the automotive and media industries.

CONTINUING DIRECTORS

Ernest Garcia III co-founded Carvana and has served as our president and chief executive officer since our inception in 2012. Mr. Garcia is also Chairman of the Carvana Co. Board. Prior to founding Carvana, Mr. Garcia held various roles at DriveTime from January 2007 to January 2013. From January 2007 to December 2008, he served as a financial strategist. He was a managing director of corporate finance from December 2008 to November 2009. From November 2009 until January 2013, he served as a vice president and treasurer and director of quantitative analytics. As director of quantitative analytics, Mr. Garcia was responsible for the firm's ongoing development of consumer credit scoring models, and its utilization of those tools in retail-vehicle-sales deal structuring and vehicle-price optimization. Prior to DriveTime, Mr. Garcia was an associate in the Principal Transactions Group at RBS Greenwich Capital from 2005 to 2006, where he focused on consumer-credit-based investments. Mr. Garcia holds a B.S. in management science and engineering from Stanford University. We believe that Mr. Garcia is qualified to continue to serve on our Board because of his extensive knowledge of our business and strategy, as well as his experience in the automotive retail industry and leadership role with us.

Ira Platt has served on our Board since the completion of our IPO in 2017. Mr. Platt has been the president of Georgiana Ventures, LLC, a firm that provides equity and debt capital to specialty finance companies, acquires portfolios of consumer finance receivables and offers consulting services to the specialty finance industry, since its inception in 2009. From May 2009 to December 2013, Mr. Platt served as the president of 221 Capital Partners, LLC, a firm that provides advisory services. From 2009 to 2011, Mr. Platt was the portfolio manager for the Rosemont TALF Opportunity Fund, a partnership investing in asset-backed securities. In addition, Mr. Platt was a managing director and head of the Principal & Distressed Capital Business for RBS Greenwich Capital, the domestic fixed-income banking unit of the Royal Bank of Scotland Group, from 1997 to 2009. Mr. Platt was an executive vice president of the Aegis Consumer Funding Group, a publicly traded non-prime automotive finance company, from 1991 to 1997. Mr. Platt earned a B.A. degree in 1985 from Emory University and an M.B.A. from The Fuqua School of Business at Duke University. Mr. Platt served on DriveTime's board of directors from February 2014 until April 2017. We believe that Mr. Platt will continue to be a valuable member of our Board because of his service on DriveTime's board and his extensive experience in consumer finance and the automotive retail industry.

Michael Maroone has served on our Board since the completion of our IPO. Mr. Maroone is currently the CEO of Maroone U.S.A. LLC. From July 2005 to April 2015, Mr. Maroone served on the board of AutoNation, Inc., an automotive retailer and provider of new and used vehicles and related services. From August 1999 until his retirement in February 2015, Mr. Maroone also served as president and chief operating officer of AutoNation, Inc. Prior to joining AutoNation, Inc., Mr. Maroone was president and chief executive officer of the Maroone Automotive Group, a privately held automotive retail group, from 1977 to 1997. Mr. Maroone currently serves on three other boards: as a member of the board of Cox Automotive, Inc., a privately held combination of global automotive wholesale and services businesses including automotive auctions, financial services, media, and software; as chairman of the board of Cleveland Clinic Florida, a non-profit, multispecialty academic hospital; and as a member of the board of the Cleveland Clinic. Mr. Maroone previously served on the Cleveland Clinic Board of Trustees and was co-chairman of the Florida Leadership Board of the Cleveland Clinic. He holds a B.S. degree in small business management from the University of Colorado Boulder. Mr. Maroone was selected to serve on our Board because of his advisory experience and his extensive experience in the automotive retail industry

INDEPENDENCE STATUS

The listing standards of the New York Stock Exchange require that, subject to specified exceptions, each member of a listed company's audit committee, and compensation committee, and nominating committee be independent and that audit committee members also satisfy independence criteria set forth in Rule 10A-3 under the Exchange Act.

Our Board has determined that each of our non-employee directors, including our director nominees Dan Quayle and Gregory Sullivan, meets the requirements to be an independent director. In making this determination, our Board considered the relationships that each non-employee director has with Carvana and all other facts and circumstances that our Board deemed relevant in determining their independence, including beneficial ownership of our Class A common stock.

CONTROLLED COMPANY STATUS

For purposes of the corporate governance rules of the NYSE, we are a "controlled company." Controlled companies under those rules are companies of which more than 50% of the voting power for the election of directors is held by an individual, a group, or another company. The Garcia Parties beneficially own more than 50% of the combined voting power of Carvana Co. Accordingly, we expect to be eligible for, but do not currently intend to take advantage of, certain exemptions from the corporate governance requirements of the NYSE. Specifically, as a "controlled company," we would not be required to have:

- a majority of independent directors,
- a nominating and corporate governance committee composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities,
- a compensation committee composed entirely of independent directors with a written charter addressing the committee's purpose and responsibilities, or
- an annual performance evaluation of the nominating and governance and compensation committees.

In the event we choose to rely on some or all of these exemptions in the future, you would not have the same protections afforded to stockholders of companies that are subject to all of the applicable corporate governance rules of the NYSE.

BOARD MEETINGS AND COMMITTEES

During the year ended December 31, 2018, our Board held five meetings, our Audit Committee held nine meetings, and our Compensation and Nominating Committee held four meetings. Directors are expected to attend the annual meeting of stockholders and all or substantially all of the Board meetings and meetings of committees on which they serve, and to spend the time needed and meet as frequently as necessary to properly discharge their responsibilities. Each director attended last year's annual meeting, 100% of the meetings of the Board during such director's tenure, and 100% of the meetings held by the committees of the Board on which the director served.

Our Board has an Audit Committee and a Compensation and Nominating Committee. The composition, duties and responsibilities of these committees are as set forth below. In the future, our board may establish other committees, as it deems appropriate, to assist it with its responsibilities.

BOARD MEMBER	AUDIT COMMITTEE	COMPENSATION AND NOMINATING COMMITTEE
Ira Platt	•	•
Gregory Sullivan	•	•
Dan Quayle		•
Michael Maroone	•	

AUDIT COMMITTEE

The Audit Committee is responsible for, among other matters,

- appointing, compensating, retaining, evaluating, terminating, and overseeing our independent registered public accounting firm;
- discussing with our independent registered public accounting firm their independence from management;
- reviewing with our independent registered public accounting firm the scope and results of their audit;
- approving all audit and permissible non-audit services to be performed by our independent registered public accounting firm;
- overseeing the financial reporting process and discussing with management and our independent registered public accounting firm the interim and annual financial statements that we file with the SEC;

- reviewing and monitoring our accounting principles, accounting policies, financial and accounting controls, and compliance with legal and regulatory requirements;
- establishing procedures for the confidential anonymous submission of concerns regarding questionable accounting, internal controls, or auditing matters;
- reviewing and approving related party transactions; and
- overseeing our enterprise risk management program.

Our Board has affirmatively determined that Mr. Platt, Mr. Maroone, and Mr. Sullivan meet the definition of "independent director" for purposes of serving on an Audit Committee under Rule 10A-3 of the Exchange Act and the NYSE rules. In addition, our Board has determined that Mr. Platt qualifies as an "audit committee financial expert," as such term is defined in Item 407(d)(5) of Regulation S-K. The written charter for our Audit Committee is available at our corporate website at investors.carvana.com/corporate-governance/governance-documents.

COMPENSATION AND NOMINATING COMMITTEE

The Compensation and Nominating Committee is responsible for, among other matters,

- reviewing key employee compensation goals, policies, plans, and programs;
- reviewing and providing recommendations to the Board regarding the compensation of our directors, chief executive officer, and other executive officers;
- reviewing and approving employment agreements and other similar arrangements between us and our executive officers;
- administering stock plans and other incentive compensation plans;
- identifying individuals qualified to become members of our Board, consistent with criteria approved by our Board;
- overseeing the organization of our Board to discharge the Board's duties and responsibilities properly and efficiently;
- identifying best practices and recommending corporate governance principles; and
- developing and recommending to our Board a set of corporate governance guidelines and principles applicable to us.

The Board has adopted a written charter for the Compensation and Nominating Committee, which is available on our corporate website at investors.carvana.com/corporate-governance/governance-documents. Each member of our Compensation and Nominating Committee is an independent director as defined by NYSE rules.

BOARD LEADERSHIP STRUCTURE

The following section describes our board leadership structure, the reasons why the structure is in place at this time, the roles of various positions, and related key governance practices. The mix of experienced independent and management directors that make up our Board, along with the independent role of our lead director and our independent board-committee composition, benefits Carvana and its stockholders.

INDEPENDENCE; BOARD MIX

Our Board has an effective mix of independent and management directors. It is composed of four independent directors and our current chairman and chief executive officer, Ernest Garcia III.

LEAD DIRECTOR

The Board believes that it is beneficial to Carvana and its stockholders to designate one of the directors as a lead director who is elected by a majority of the Board. The lead director serves a variety of roles, including reviewing and approving Board schedules to confirm the appropriate board and committee topics are reviewed and sufficient time is allocated to each; liaising between our chairman and chief executive officer and non-management directors when necessary and appropriate (that said, each director has direct and regular access to the chairman and chief executive officer) and calling an executive session of independent directors at any time consistent with the bylaws and certificate of incorporation. Michael Maroone, an independent director and member of our Audit Committee, is currently our lead director. Mr. Maroone is an effective lead director for Carvana due to, among other things, his independence, his board leadership experience with AutoNation, Inc., his strong strategic and financial acumen, his commitment to ethics, his extensive knowledge of the automotive retail environment, and his deep understanding of Carvana and its business.

CHAIRMAN / CEO

With respect to the roles of chairman and CEO, the corporate governance guidelines provide that the roles may be separated or combined, and the Board will exercise its discretion in combining or separating these positions as it deems appropriate in light of prevailing circumstances. Mr. Garcia has been our chairman and CEO since our IPO. The Board believes that combining the roles of chairman and CEO, together with the separate, independent role of our lead director, is currently the most effective leadership structure because Mr. Garcia has extensive knowledge and experience in a variety of relevant areas acquired through his professional and other experiences, including automotive retail, e-commerce, consumer finance and strategic planning. This knowledge and experience give Mr. Garcia the insight necessary to combine the responsibilities of strategic development and execution along with management of day-to-day operations.

SELF-EVALUATION

Our Compensation and Nominating Committee conducts an annual performance evaluation to determine whether the Board, its committees, and the directors are functioning effectively. This includes survey materials as well as conversations between each director and the lead director. The evaluation focuses on the Board's and the committees' contributions to Carvana and has an enhanced focus on areas in which the Board or management believes that the Board could improve.

As part of the annual Board self-evaluation, the Board evaluates whether the current leadership structure continues to be appropriate for Carvana and its stockholders. Our corporate governance guidelines provide the flexibility for our Board to modify our leadership structure in the future as appropriate.

SECTION 16(A) BENEFICIAL OWNERSHIP REPORTING COMPLIANCE.

Section 16(a) of the Exchange Act requires our directors, executive officers and greater-than-ten-percent stockholders to file initial reports of ownership and reports of changes in ownership of any of our securities with the SEC and us. We believe that during the 2018 fiscal year, all of our directors, executive officers and greater-than-ten-percent stockholders complied with the requirements of Section 16(a).

RISK OVERSIGHT

The Board, as a whole and through the Audit Committee, oversees our risk management program, which is designed to identify, evaluate, and respond to our high priority risks and opportunities. The risk management program facilitates constructive dialog at the senior management and board level to proactively realize opportunities and manage risks. Our Audit Committee is primarily responsible for overseeing our risk management processes on behalf of the full board. Our management, including our executive officers, is primarily responsible for managing the risks associated with the operation and business of our company and provides regular updates to the Audit Committee and annual updates to the full board on the risk management program and reports on the identified high priority risks and opportunities.

CODE OF ETHICS AND CONDUCT

We have adopted a code of business conduct and ethics that applies to all of our employees, officers, and directors, including those officers responsible for financial reporting. Our code of business conduct and ethics is available on our website at investors.carvana.com/corporate-governance/governance-documents. We intend to disclose any amendments to the code or waivers of its requirements on our website.

COMPENSATION COMMITTEE INTERLOCKS AND INSIDER PARTICIPATION

No interlocking relationships exist between the members of our Board and the board or compensation committee of any other company.

COMMUNICATIONS BY STOCKHOLDERS AND OTHER INTERESTED PARTIES WITH THE BOARD OF DIRECTORS

Stockholders and other interested parties may contact an individual director, the lead director, the Board as a group, or a specified board committee or group, including the non-management directors as a group, by sending regular mail to

Carvana Co.
1930 W. Rio Salado Pkwy
Tempe, AZ 85281
ATTN: Board of Directors

or by email at leaddirector@carvana.com.

Each communication should specify which director or directors the communication is addressed to, as well as the general topic of the communication. Carvana will receive the communications and process them before forwarding them to the addressee. Carvana may also refer communications to other departments within Carvana. Carvana generally will not forward to the directors a communication that is primarily commercial in nature, relates to an improper or irrelevant topic, or requests general information regarding Carvana.

DIRECTOR COMPENSATION

Prior to our IPO, none of our directors received compensation as a director from us. We have designed our non-employee director compensation program to achieve the following objectives:

- align directors' interests with the long-term interests of our shareholders;
- attract and retain outstanding director candidates with diverse backgrounds and experiences; and
- recognize the substantial time commitment required to serve as a Carvana director.

The Compensation and Nominating Committee reviews the Company's director compensation program annually. Independent directors may not receive, directly or indirectly, any consulting, advisory or other compensatory fees from us. Members of the Board who are employees of Carvana do not receive compensation for their service on the Board. The following table presents summary information regarding the total compensation awarded to, earned by, and paid to our non-employee directors for the year ended December 31, 2018:

NAME	FEES EARNED OR PAID IN CASH ($)	OPTION AWARDS ($)	ALL OTHER COMPENSATION ($)	TOTAL ($)
Ira Platt	100,000	—	—	100,000
Gregory Sullivan	95,000	—	—	95,000
Dan Quayle	70,000	—	—	70,000
Michael Maroone	90,000	—	—	90,000

NON-EMPLOYEE DIRECTOR COMPENSATION STRUCTURE

As of March 7, 2019, we compensate our non-employee directors according to the following structure:

DESCRIPTION	AMOUNT
Annual retainer	$60,000
Board meeting fees	$2,000 per each board meeting in excess of six board meetings in any calendar year that a non-employee director attends in person
Additional retainer for committee members	$10,000 per committee
Additional retainer for chair of committee	$20,000 for Audit Committee; $15,000 for Compensation and Nominating Committee
Additional retainer for lead director	$20,000

Additionally, upon the completion of our IPO, each current non-employee director received a one-time award of options to purchase an aggregate of approximately 30,927 shares of our Class A common stock, vesting over three years, with an exercise price of $15. All non-employee directors are also reimbursed for their reasonable expenses to attend meetings of our Board and related committees and otherwise attend to our business.

EXECUTIVE OFFICERS

Below is a list of the names, ages, positions, and a brief account of the business experience of the individuals who serve as executive officers of Carvana Co. as of April 23, 2019:

NAME	AGE	POSITION
Ernest Garcia III	36	President, Chief Executive Officer and Chairman
Mark Jenkins	40	Chief Financial Officer
Benjamin Huston	36	Chief Operating Officer
Ryan Keeton	41	Chief Brand Officer
Daniel Gill	36	Chief Product Officer
Paul Breaux	35	Vice President, General Counsel and Secretary

Ernest Garcia III is the president and chief executive officer of Carvana and the chairman of our Board. His biography can be found above under "Board of Directors and Corporate Governance – Continuing Directors."

Mark Jenkins has served as our chief financial officer since July 2014. Prior to joining Carvana, Mr. Jenkins was a professor in the finance department at the Wharton School of the University of Pennsylvania from 2009 to 2014, where his teaching and research focused on consumer and corporate credit markets. While at Wharton, Mr. Jenkins was responsible for teaching courses in the undergraduate, MBA, and executive education programs on corporate restructuring, corporate credit, and leveraged finance. Prior to his time at Wharton, Mr. Jenkins worked at the Brattle Group from 2001 to 2004, an economic consulting firm, where he focused on corporate valuation and demand forecasting in technology markets. Mr. Jenkins received a Ph.D. in economics from Stanford University and a B.S.E. from Duke University in mathematics and civil engineering.

Benjamin Huston co-founded Carvana and has served as our chief operating officer since our inception in 2012. In 2011, prior to joining Carvana, Mr. Huston co-founded Looterang, a card-linking platform that enabled personalized deals to be automatically administered through consumer credit or debit cards. Mr. Huston was chief executive officer of Looterang from 2011-2012. From 2008 to 2011, Mr. Huston served as an associate at Latham and Watkins, a full-service global law firm, where he focused on regulatory affairs. Mr. Huston holds a J.D. from Harvard Law School and a B.A. in American studies from Stanford University.

Ryan Keeton co-founded Carvana and has served as our chief brand officer since our inception in 2012. Prior to joining Carvana, Mr. Keeton was a principal at the Montero Group, a strategic consultancy firm, from 2010 to 2012, where he advised global public and private companies on strategic and business initiatives. From 2008 to 2010, Mr. Keeton served as director of strategic marketing for George P. Johnson, a global marketing agency. Mr. Keeton holds a B.A. in English and American literature and language from Harvard University.

Daniel Gill has served as our chief product officer since March 2015, overseeing all technology functions, as well as strategic partnerships for the business. Prior to joining Carvana, Mr. Gill spent his career in both enterprise software and consumer internet businesses. He co-founded and served as CEO of Huddler from 2007 until the company's acquisition by Wikia in May of 2014. Mr. Gill holds a degree in biology from Stanford University.

Paul Breaux has served as our general counsel since August 2015. Prior to joining Carvana, Mr. Breaux practiced law at the Houston, Texas office of the firm Andrews Kurth LLP (now Hunton Andrews Kurth LLP) from 2008 to 2015. While at Andrews Kurth, Mr. Breaux's representative experience encompassed a broad range of general business transactions matters. Mr. Breaux holds a J.D. from Harvard Law School, a B.A. in Plan II Honors from The University of Texas at Austin, and a B.B.A. in finance from The University of Texas at Austin.

COMPENSATION DISCUSSION AND ANALYSIS

This Compensation Discussion and Analysis ("CD&A") describes our executive compensation objectives and design, our compensation-setting process, our executive compensation program components, and the decisions made in 2018 with respect to our chief executive officer and our four other most highly compensated executive officers for the year ended December 31, 2018, who have been designated as our "named executive officers" under Item 404 of Regulation S-K ("NEOs"):

NAMED EXECUTIVE OFFICER	POSITION
Ernest Garcia III	Chief Executive Officer
Mark Jenkins	Chief Financial Officer
Benjamin Huston	Chief Operating Officer
Ryan Keeton	Chief Brand Officer
Daniel Gill	Chief Product Officer

This CD&A may contain statements regarding future individual and company performance targets and goals. These targets and goals should not be understood to be statements of management's expectations or estimates of results or other guidance. We specifically caution investors not to apply these statements to other contexts.

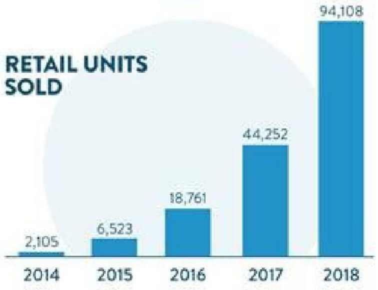
EXECUTIVE SUMMARY

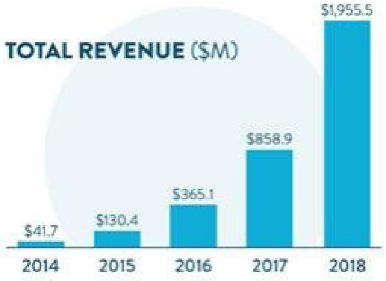
COMPANY PERFORMANCE HIGHLIGHTS

2018 was a successful year for Carvana. We had another year of triple-digit growth in unit retails sold and revenue, while making significant progress in our gross profit per unit and EBITDA margin. Our growth has few historical precedents and makes us one of the fastest-growing technology, consumer, or retail companies at our scale.

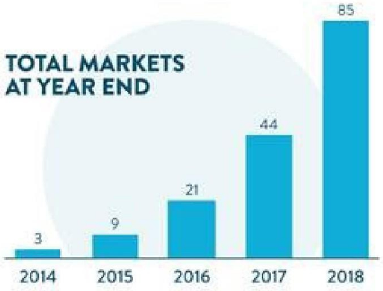
The highlights of our 2018 performance include:

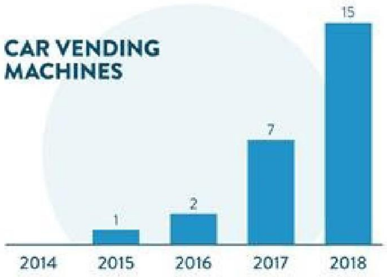
- 113% increase in retail units sold, from 44,252 to 94,108;
- 128% revenue growth, from $859 million to $1.96 billion;





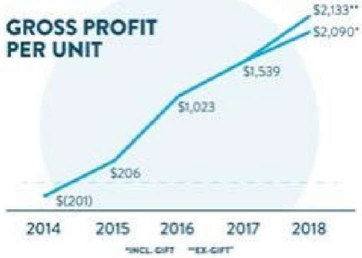
- 41 new markets, bringing our total from 44 to 85;
- 8 additional car vending machines, bringing our total from 7 to 15;

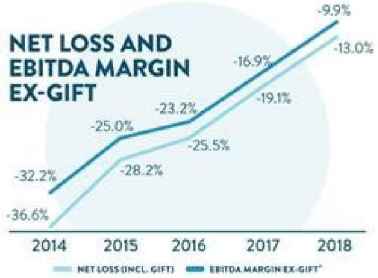




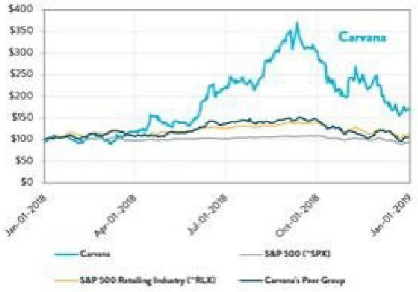
- a $551 increase in gross profit per unit (incl. gift) from $1,539 to $2,090, and a $594 increase in gross profit per unit ex-Gift, from $1,539 to $2,133;
- an increase in net loss margin (incl. Gift) from (19.1%) to (13.0%);
- an increase in EBITDA margin ex-Gift, from (16.9%) to (9.9%); and

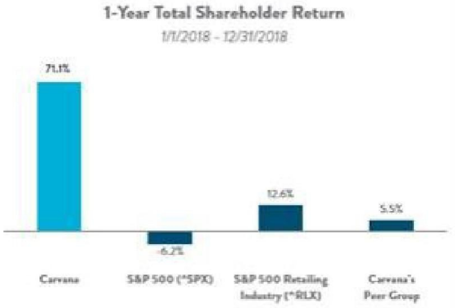
Note that gross profit per unit ex-gift and EBITDA margin ex-gift are non-GAAP measures. A description of these measures and a reconciliation of these measures to the nearest comparable GAAP measure can be found in the annex of this proxy statement .





- a one-year total shareholder return of 71.1%, significantly outperforming our peer group companies (see "Competitiveness of our Compensation Program" below) as an index as well as the S&P 500 and S&P 500 Retailing Indices.





KEY COMPENSATION DESIGN AND DECISIONS TO LINK PAY AND PERFORMANCE

Underlying our executive compensation program is a strong belief in promoting a pay-for-performance culture. We accomplish this by linking a significant portion of the compensation of our executive officers, including our named executive officers, to our performance. In addition, the Compensation and Nomination Committee seeks to set challenging threshold and target performance levels that reflect our rapid growth trajectory and business plans rather than goals based on prior years' achievements. For each of the metrics used in our performance-based compensation plans, payouts are earned based upon outstanding performance as measured against pre-established financial objectives.

CORPORATE GOVERNANCE HIGHLIGHTS REGARDING EXECUTIVE COMPENSATION

We endeavor to maintain sound executive compensation policies and practices, including compensation-related corporate governance standards, consistent with our executive compensation philosophy. The following summarizes our executive compensation and related governance policies and practices:

WHAT WE DO

- ✓ A significant portion of compensation is “at risk” and tied to long-term company performance
- ✓ Annual incentive plan metrics are solely based on company performance; awards are determined based on pre-established targets
- ✓ Market-based executive compensation levels are reviewed by Compensation and Nominating Committee annually
- ✓ Performance-measured incentive awards are subject to a compensation recoupment policy
- ✓ Executives are prohibited from hedging
- ✓ An independent compensation consultant is retained to evaluate our executive compensation and make recommendations

WHAT WE DO NOT DO

- × No discretionary or guaranteed incentives payments
- × No new or legacy exercise-tax gross-up provisions
- × No option repricing without stockholder consent

We believe that we have designed executive compensation plans that effectively support our strategic and financial goals, create a culture of teamwork, and are directly tied to the performance of the company and shareholder outcomes. We will continue to utilize rigorous governance processes to monitor and evaluate the compensation programs as well as implement best practices in compensation governance. We welcome shareholder feedback on our programs.

COMPENSATION OBJECTIVES AND PRINCIPLES

Carvana seeks to create and maintain a culture of teamwork and high performance. Our executive compensation programs are one of the tools we utilize to accomplish this objective. Philosophically, we aim to treat our executives fairly when considering:

- the complexity of their jobs,
- the market for their executive talent,
- their individual performance,
- the financial and strategic performance of the company, and
- the need to retain the executives.

Within that framework, it is critical that we meet our objectives to:

- attract and retain the best executive talent to support our growth,
- align the interests of our executives with those of our shareholders, and
- provide incentives that are linked directly to our long- and short-term strategy.

We set very challenging goals as our incentive compensation metrics and we expect that our executives will in aggregate be paid approximately at the median for achieving those goals through the plans outlined in this CD&A. As evidenced by our track record of growth and strategic progress, our approach to executive compensation has been effective.

COMPETITIVENESS OF OUR COMPENSATION PROGRAM

Our executive compensation program is designed so that the sum of base pay plus total short- and long-term compensation is competitive with market practices. Market practices—or benchmarks—are based on peer-group data and compensation survey data.

The past year, 2018, was our first year of developing a compensation peer group. Many of our direct industry competitors are either privately held companies or are larger than us in revenue size, although very few have our growth trajectory. The Compensation and Nominating Committee, with the assistance of its compensation consultant, Korn Ferry, reviewed and selected potential peer companies based on revenue size, industry focus, growth rates, complexity of operations, customer base, and market for talent. With the assistance of its compensation consultant, the committee approved the following compensation peer group in order to determine market pay levels and pay practices for fiscal year 2018:

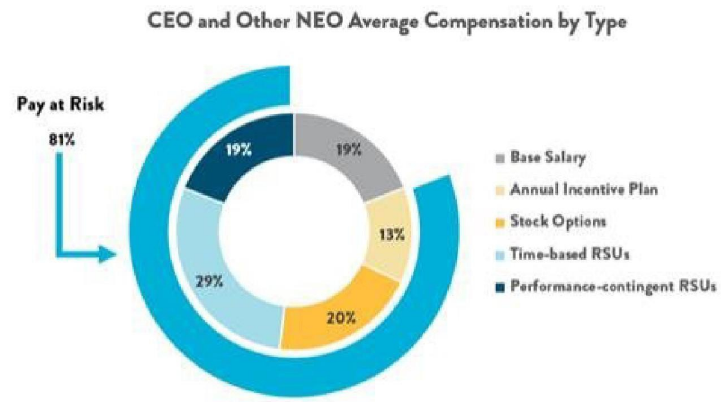
- 1-800-Flowers.com, Inc.
- America’s Car-Mart, Inc.
- Cars.com Inc.
- Etsy, Inc.
- Grubhub, Inc.
- MarineMax, Inc.
- Monro, Inc.
- Overstock.com, Inc.
- RH
- Sleep Number Corporation
- TrueCar, Inc.
- U.S. Auto Parts Network, Inc.
- Wayfair Inc.
- Zillow Group, Inc.

Going forward, the Compensation and Nominating Committee expects to review our compensation peer group on an annual basis for continued appropriateness, considering changes in both our size and business and the businesses of the companies in the peer group.

The committee also uses compensation survey data in its evaluation of executive pay for the NEOs. Survey data provides insight into positions that may not generally be reported in proxy statements and information about the compensation of executives of non-public companies. To assist the committee in evaluating fiscal year 2018 compensation levels, the committee reviewed both peer-group proxy data and information from survey databases, utilizing appropriate subsets based on the size of the company.

COMPENSATION COMPONENTS

In accordance with our overall compensation philosophy and program, executives are provided with a mix of base salary, short-term incentives, long-term incentives and employee benefits. Our compensation philosophy places a significant portion of the potential total compensation for each NEO “at risk” such that compensation will vary based on performance of Carvana. Variable compensation is a component of compensation for most of our employees, but a higher proportion of our NEOs’ compensation is at risk than that of our general employee population. As shown in the pay mix chart below, our compensation program is designed to be highly performance-based with approximately 80% of each of our NEO’s compensation tied to our financial performance and stock price performance.


CEO and Other NEO Average Compensation by Type

The following table describes the material elements of compensation and the objectives of each element:

PROGRAM	DESCRIPTION	OBJECTIVES
ANNUAL COMPENSATION:		
Base Salary	• Ongoing cash compensation based on executive officer's role, responsibilities, competitive market positioning, and individual performance.	• Attract and retain qualified key managerial talent. • Recognize sustained individual performance.
Annual Incentive Plan	• Annual cash incentive with target award amounts for each executive officer. • Actual cash awards may be higher or lower than target, based on the company's financial performance.	• Attract and retain qualified key managerial talent. • Encourage and reward achievement of annual performance objectives.
LONG-TERM COMPENSATION:		
Long-Term Incentive Program	• A long-term incentive program using a combination of time-vested and performance-based awards.	• Focus executives on long-term company performance and long-term financial and strategic success. • Retention. • Align employee and stockholder interests via performance goals and stock ownership.

The resulting payout range for Mr. Garcia, our chief executive officer, is $0–$530,667, with a target of $266,667. For both Mr. Jenkins, our chief financial officer, and Mr. Huston, our chief operating officer, the payout range is $0–$497,500, with a target of $250,000. For both Mr. Keeton, our chief brand officer, and Mr. Gill, our chief product officer, the payout range is $0–$437,800, with a target bonus of $220,000.

Performance Metrics and Goals

The performance period for the annual incentive is our fiscal year. The committee selected retail units sold, gross profit per unit ex-Gift, and EBITDA margin ex-Gift as the performance metrics for our 2018 annual incentive plan because these are the primary metrics we use in evaluating our own performance when communicating our financial results to our investors.

The committee believes that these performance measures help focus the executives on growing retail units sold and revenue, increasing total gross profit per unit, and demonstrating operating leverage. The detailed definition of each measure and rationale of selection are provided below:

PERFORMANCE METRICS USED IN THE 2018 AIP	WEIGHT	DEFINITION	RATIONALE OF SELECTION
Retail Units Sold	40%	The number of vehicles sold to customers in a given period, net of returns under our seven-day return policy.	We view retail units sold as a key measure of our growth for several reasons. First, retail units sold is the primary driver of our revenues and, indirectly, gross profit, since retail unit sales enable multiple complementary revenue streams, including financing, VSCs, GAP waiver coverage, and trade-ins. Second, growth in retail units sold increases the base of available customers for referrals and repeat sales. Third, growth in retail units sold is an indicator of our ability to successfully scale our logistics, fulfillment, and customer service operations.
Gross Profit per Unit ex-Gift	40%	The gross profit before compensation expense related to the 100k Milestone Gift (as hereinafter defined) is included in cost of sales, divided by retail units sold in that period.	Total gross profit per unit ex-Gift is driven by sales of used vehicles, each of which generates additional revenue sources including wholesale sales of vehicles we acquire from customers as trade-ins, gains on the sales of loans originated to finance the vehicle, revenue from GAP waiver coverage, and commissions on sales of VSCs. We believe total gross profit per unit ex-Gift is a key measure of our growth and long-term profitability.

EBITDA Margin ex-Gift	20%	Net loss before interest expense, income tax expense, depreciation and amortization expense, and the compensation expense related to the 100k Milestone Gift, as a percentage of total revenues.	We believe that EBITDA Margin ex-Gift is an important measure of the leverage in our business and a useful measure to us and to our investors because it focuses specifically on operational performance.

At the beginning of 2018, the committee established financial performance goals that were challenging and reflective of Carvana's fiscal 2018 operating plan, economic and market conditions, and forecasts at the time the performance goals were established. The target performance goal of each metric is significantly above fiscal 2017's actual results: over 92,000 retail units sold, a 108% increase over fiscal year 2017's retail units sold of 44,252; over $2,100 for gross profit per unit ex-Gift, a $561 increase over fiscal year 2017's gross profit per unit ex-Gift of $1,539; and EBITDA margin ex-Gift of less than (7.2)%, a 9.7 percentage point improvement over fiscal year 2017's EBTIDA margin ex-Gift of (16.9)%.

Total Payouts

Based on the committee's evaluation of our 2018 actual performance against the annual incentive plan goals, 88% of the target annual bonuses were paid out, amounting to 59% of the NEOs' respective base salaries. The annual incentive bonus received by each of the NEOs is included in the "Non-Equity Performance Incentive Plan Compensation" column in the 2018 Summary Compensation Table in this proxy statement.

Each of the annual incentive metrics provided a payout range of 0%–199% as a percent of the target. For Retail Units Sold, weighted 40% of the total, the target was over 92,000, and our actual performance was 94,108, resulting in a payout of 118% of the target payout. For gross profit per unit ex-Gift, weighted 40% of the total, the target was over $2,100 and our actual performance was $2,133, resulting in a payout of 103% of the target. For EBITDA Margin ex-Gift, weighted 20% of the total, our target was less than (7.2)% and our actual performance was (9.9)%, resulting in no payout. Aggregating each of the respective payouts, weighted accordingly, resulted in a total payout of 88% of target. Applying the payout of 88% of target to each of our NEOs respective target bonuses, Mr. Garcia achieved a $235,733 payout amount; Messrs. Jenkins and Huston achieved a payout of $221,000 each, and Messrs. Keeton and Gill achieved a payout of $194,480 each.

LONG-TERM INCENTIVE PROGRAM

The Compensation and Nominating Committee believes that stock-based performance compensation is essential to align the interests of Carvana's management and its shareholders in enhancing the long-term value of our equity and to encourage executives to remain with the company. Among the varied types of equity awards the committee is authorized to use under the equity plan, stock options are the ones that the committee has determined are preferable for use with NEOs, because their value is more leveraged to future value appreciation and depends upon a future increase in the value of our common stock. The committee also has determined that restricted stock unit grants to NEOs should be used for the purposes of retention or recognition of outstanding performance in part because restricted stock units are less volatile than stock options.

2018 Annual Grant

For fiscal 2018, the Compensation and Nominating Committee determined to award an equal blend of time-based stock options and restricted stock units to provide a mix composed of awards whose value depends upon a future increase in the value of the common stock (time-based stock options) and awards that serve primarily as a retention tool (time-based restricted stock units).

For the 2018 annual grant, the committee targeted a grant value equal to the amount of each executive's base salary. The committee initially targeted the annual grant based on a 10-day average stock price as of April 2, 2018 ($21.61). Based on that price, Mr. Garcia would have received 15,988 options and 9,255 RSUs; Messrs. Jenkins and Huston would have received 14,989 options and 8,677 RSUs; and Messrs. Keeton and Gill would have received 13,190 options and 7,635 RSUs. However, the grants were not awarded until mid-July when the stock price had more than doubled ($44.21). To compensate the executives for the disadvantage of receiving stock options with a much higher exercise price, the Committee determined to grant additional RSUs. The grant value of the additional RSUs is equal to one-half of the in-the-money value difference between the options granted based on the March stock price and the options granted based on the July stock price, resulting in a total of 13,987 RSUs granted to Mr. Garcia, 13,113 to Messrs. Jenkins and Huston each, and 11,540 to Messrs. Keeton and Gill each.

2018 Special Performance-Contingent Grant

For fiscal 2018, the Compensation and Nominating Committee and the Board also granted a one-time special performance-contingent RSU award for driving exceptional company performance to achieve an important milestone in the development of the business. The RSUs were granted on April 30, 2018, to the NEOs other than the CEO; the CEO received his award on May 1, 2018. Mr. Garcia was granted 14,572 RSUs ($393,298 grant value), Messrs. Jenkins and Huston 13,662 RSUs ($358,081 grant value), and Messrs. Keeton and Gill 12,022 RSUs ($315,097 grant value). All of these grants will vest 100% on the date of the first periodic report filed where positive quarterly EBITDA is reported. None of the RSUs were vested as of the end of 2018.

2018 100k Milestone Gift

On September 10, 2018, we announced a commitment by our chief executive officer, Ernest Garcia III ("Mr. Garcia"), to contribute 165 shares of Class A common stock to us from his personal shareholdings for every one of our then-existing employees, including the NEOs, upon their satisfying certain employment tenure requirements. In connection with these contributions, we have made corresponding grants of 165 restricted stock units under our 2017 Omnibus Incentive Plan to each employee who has satisfied the requirements and we intend to make grants to the remaining then-existing employees as they satisfy the requirements (the "100k Milestone Gift" or "Gift"). Messrs. Jenkins, Huston, Keeton, and Gill all received the grant in 2018, which had a grant date fair value of $10,562.

PERQUISITES AND BENEFITS

Currently, we do not view perquisites or other personal benefits as a significant component of our executive compensation program. Accordingly, we did not provide perquisites to our executive officers in 2018, including our named executive officers, except that each of the NEOs, along with certain other employees, can use one of the company inventory vehicles (which generally will be replaced every three years); each, along with many of our employees, may use a company-provided cellular phone; and each, along with all of our employees, may participate in our 401(k) match benefit which is based on salary.

We do not expect that any future perquisites or other personal benefits will be a significant aspect of our executive compensation program. All future practices with respect to perquisites or other personal benefits will be approved and subject to periodic review by the Compensation and Nominating Committee.

TERMINATION, SEVERANCE AND CHANGE IN CONTROL BENEFITS

We do not have employment or severance agreements with our executives.

In the event of a change in control of Carvana Group, all outstanding unvested Class B Unit awards held by participants in the Carvana Group equity incentive plan, whose employment has not previously terminated, will accelerate in full, subject to certain escrow demand rights held by a purchaser of control of Carvana Group.

If an executive is terminated involuntarily without cause within twenty-four months following a change in control as defined by our 2018 equity award agreements, all outstanding vested stock options and time-based RSUs of that executive will become fully exercisable or vested. An executive whose employment is terminated because of death or disability will receive one year from the time of termination to exercise any then-vested options instead of the usual 90 days, but not past the expiration date of the options. If a person’s employment is terminated for disability, and that person later dies within a year, the legal representative of the person’s estate may exercise the options within one year of the date of death, though not past the expiration date of the options.

If a change in control occurs before the performance-contingent RSUs are vested, outstanding shares will vest in a proportionate number based on the company’s progress toward positive EBITDA, starting from the EBITDA loss baseline as of the end of the calendar quarter immediately preceding the award (-$41.5 million) to the EBITDA as of the end of the calendar quarter immediately preceding the date of the closing of the change in control.

Except for these arrangements, none of our named executive officers have entered into any plans, arrangements or agreements with Carvana providing for payments upon termination of employment or change in control of Carvana, other than payments generally available to all salaried employees that do not discriminate in scope, terms, or operation in favor of the executive officers of Carvana.

COMPENSATION-RELATED POLICIES

COMPENSATION RECOVERY ("CLAWBACK") POLICY

In 2018, the Compensation and Nominating Committee approved the adoption of a "clawback" policy, which would provide for the clawback or recoupment of any compensation granted, earned, or vested that is tied to performance metrics, in the event of an accounting restatement resulting from material noncompliance with certain financial reporting requirements that reveals that such performance (or level of performance) was not achieved.

POLICY REGARDING HEDGING AND PLEDGING OF COMPANY STOCK

Carvana's insider trading policy prohibits all employees from buying or selling Carvana securities while aware of material nonpublic information and prohibits the disclosure of material nonpublic information to others who then trade in our securities. As part of this policy, certain other Carvana-securities-related transactions by directors, officers and other employees are also prohibited or subject to specific notice and pre-approval requirements. The policy is premised on the belief that even in those circumstances where the proposed transaction may not constitute a violation of law or applicable regulations, it is nonetheless inappropriate for any director, officer, or other employee to engage in short-term or speculative transactions in our securities which may be viewed as reducing their incentive to improve our performance or inconsistent with the objectives of our stockholders in general. Therefore, it is our policy that directors, officers, and other employees may not engage in any transactions involving our securities which constitute short sales, puts, calls, or other similar derivative securities. The policy also prohibits certain other transactions, including hedging or monetization transactions—e.g., zero-cost collars, forward sale contracts, and arrangements pledging company securities as collateral for a loan (without adequate assurance of other available assets to satisfy the loan).

COMPENSATION AND RISK

We believe that our compensation programs create appropriate incentives to drive sustained, long-term increases in shareholder value. These programs have been designed and administered in a manner that discourages undue risk-taking by employees. Relevant features of these programs include:

- Focus on weighting compensation toward four-year and greater vesting schedules of equity awards;

- individual executive pay generally targeted at median level against comparable executive roles at an appropriate set of peer companies, except the chief executive officer, for whom we target significantly below median level due to his significant ownership interest in us;
- robust clawback policies permitting the recoupment of past incentive pay from executive officers in the event of certain kinds of misconduct, and forfeiture of incentive awards in the event the executive engages in various types of conduct deemed detrimental to Carvana's interests, including theft or fraud against Carvana and engaging in competition with Carvana;
- no employment agreements with executive officers;
- the use of retail units sold, gross profit per unit ex-Gift and EBITDA margin ex-Gift as performance metrics, which incents employees to increase earnings and manage net assets efficiently;
- restrictions on trading in Carvana Class A common stock to reduce insider trading compliance risk, as well as prohibitions on pledging and hedging Carvana capital stock.

In light of these features, we conclude that the risks arising from our executive and employee compensation policies and practices are not reasonably likely to have a material adverse effect on the company.

TAX AND ACCOUNTING IMPLICATIONS

Carvana considers the tax and accounting aspects of the elements of compensation we offer in determining the most effective method for compensating our executives. This includes, but is not limited to, Section 162(m) of the Internal Revenue Code and the regulations thereunder. Section 162(m) generally limits the tax deduction available to public companies for annual compensation paid to the chief executive officer and certain other named executive officers in excess of $1 million.

As a result of 2017 tax legislation, compensation paid in a fiscal year in excess of $1 million to, or on behalf of, an individual who is a "covered employee" is not expected to be deductible under Section 162(m) of the Internal Revenue Code, unless such compensation qualifies for transition relief (relating to written binding contracts in effect on November 2, 2017, which were not subsequently materially modified). Therefore, certain compensation paid under our existing equity plans and certain of our long-term equity awards originally designed with the intent that such amounts qualify as "performance-based" compensation may not be deductible in the future. Although the committee may consider the effect that Section 162(m) and the potential lack of deduction for amounts paid in excess of the deduction limit may have on Carvana, the committee continues to retain flexibility to make compensation decisions, in the exercise of its business judgment, that are based on factors that it determines to be appropriate (as determined by the committee in its sole discretion) to enable Carvana to continue to attract, retain, reward, and motivate its highly-qualified executives. This flexibility may include amending or modifying the design elements of our historical compensation programs.

COMPENSATION AND NOMINATING COMMITTEE REPORT

The Compensation and Nominating Committee has reviewed and discussed the foregoing Compensation Discussion and Analysis with management. Based on this review and discussion, the Committee recommended to the Carvana, Co. Board of Directors that the Compensation Discussion and Analysis be included in this proxy statement and incorporated by reference into Carvana Co.'s Annual Report on Form 10-K for the fiscal year ended December 31, 2018.

Respectfully submitted by:

Gregory Sullivan
Ira Platt
Dan Quayle

COMPENSATION TABLES

SUMMARY COMPENSATION TABLE

The following table presents summary information regarding the total compensation awarded to, earned by, and paid to our named executive officers for the past three fiscal years.

NAME AND PRINCIPAL POSITION	YEAR	SALARY ($)	STOCK AWARDS ($) (1)	OPTION AWARDS ($)	NON-EQUITY INCENTIVE PLAN COMPENSATION ($) (2)	ALL OTHER COMPENSATION ($) (3)	TOTAL ($)
Ernest Garcia III	2018	400,000	1,011,664	428,329	235,733	—	2,075,726
Chief Executive Officer	2017	400,000	—	—	—	16,149	416,149
	2016	400,000	—	—	—	54,008	454,008
Mark Jenkins	2018	375,000	948,368	401,566	221,000	21,980	1,967,914
Chief Financial Officer	2017	350,000	1,408,000	—	—	12,441	1,770,441
	2016	347,923	57,200	—	—	12,294	417,417
Benjamin Huston	2018	375,000	948,368	401,566	221,000	19,903	1,965,837
Chief Operating Officer	2017	350,000	1,408,000	—	—	24,034	1,782,034
	2016	347,923	57,200	—	—	19,370	424,493
Ryan Keeton	2018	330,000	835,842	353,369	194,480	20,042	1,733,733
Chief Brand Officer	2017	315,000	528,000	—	—	21,688	864,688
	2016	315,000	17,600	—	—	19,050	351,650
Daniel Gill	2018	330,000	835,842	353,369	194,480	13,157	1,726,848
Chief Product Officer	2017	315,000	528,000	—	—	17,451	860,451
	2016	315,000	17,600	—	—	11,250	343,850

(1) The amounts reported in the Stock Awards column represent the grant date fair value of the restricted stock units and Class B Units (as hereinafter defined) granted to the named executive officers during the years presented as computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718.

(2) The amounts reported in the "Non-Equity Incentive Plan Compensation" column represent the amounts paid out under the 2018 annual incentive plan, as described above under "Compensation Discussion and Analysis."

(3) Included in "All Other Compensation" for 2016, 2017, and 2018 were the following items:

NAME	YEAR	401(K) PLAN COMPANY MATCH(i)	NON-BUSINESS AIRCRAFT USAGE(ii)	INCREMENTAL COST OF COMPANY CAR(iii)	CELLPHONE EXPENSE(iv)	TOTAL
Ernest Garcia III	2018(v)	—	—	—	—	—
	2017	—	12,782	—	3,367	16,149
	2016	—	34,349	16,460	3,199	54,008
Mark Jenkins	2018	3,115	—	18,500	365	21,980
	2017	—	—	11,538	903	12,441
	2016	—	—	12,294	—	12,294
Benjamin Huston	2018	4,489	—	14,750	664	19,903
	2017	4,200	—	18,896	938	24,034
	2016	4,200	—	11,399	3,771	19,370
Ryan Keeton	2018	6,589	—	12,750	703	20,042
	2017	6,300	—	12,750	2,638	21,688
	2016	6,300	—	12,750	—	19,050
Daniel Gill	2018	1,523	—	11,250	384	13,157
	2017	—	—	11,250	386	17,451
	2016	—	—	11,250	—	11,250

(i) Represents discretionary matching contributions under our 401(k) Plan

(ii) The 2016 and 2017 amounts for Mr. Garcia is the incremental cost to Carvana of flights relating to a personal event on the private aircraft operated by Bridgecrest Credit Company, f/k/a DT Credit Company, LLC ("Bridgecrest"), an affiliate of DriveTime, and leased by Carvana. See "Certain Relationships and Related Party Transactions – Relationship with DriveTime – Aircraft Time Sharing Agreement." The incremental cost to Carvana of aircraft used under the aircraft time sharing agreement for a non-business flight is calculated by multiplying the aircraft's per-mile variable operating cost by a flight's total mileage, which includes the mileage of an empty return flight. Variable operating costs include: (1) landing, parking, passenger ground transportation, crew travel, and flight planning services expenses; (2) supplies, catering, and crew traveling expenses; (3) aircraft fuel and oil expenses; (4) maintenance, parts, and external labor (inspections and repairs); and (5) any customs, foreign permit, and similar fees. Fixed costs that do not vary based upon usage are not included in the calculation of direct operating cost. On certain occasions, a named executive officer or a named executive officer's spouse or other family member may fly on the corporate aircraft as additional passengers. No additional direct operating cost is incurred in such situations under the foregoing methodology because the costs would not be incremental. Carvana does not pay its named executive officers any amounts in respect of taxes (so-called gross-up payments) on income imputed to them for non-business aircraft usage.

(iii) The incremental cost of the company car to us has been calculated based on the depreciation value of the vehicle.

(iv) Represents the cost of company-paid cell phone service.

(v) Mr. Garcia's "All Other Compensation" for 2018 was less than $10,000.

GRANTS OF PLAN-BASED AWARDS

		ESTIMATED FUTURE PAYOUTS UNDER NON-EQUITY INCENTIVE PLAN AWARDS (1)			ESTIMATED FUTURE PAYOUTS UNDER EQUITY INCENTIVE PLAN AWARDS (2)						
NAME	GRANT DATE	THRESHOLD ($)	TARGET ($)	MAXIMUM ($)	THRESHOLD (#)	TARGET (#)	MAXIMUM (#)	ALL OTHER STOCK AWARDS: NUMBER OF SHARES OF STOCK OR UNITS (#)	ALL OTHER OPTION AWARDS: NUMBER OF SECURITIES UNDERLYING OPTIONS (#)	EXERCISE OR BASE PRICE OF OPTION AWARDS ($/SH)	GRANT DATE FAI VALUE O STOCK AN OPTION AWARDS
Ernest Garcia III	4/30/2018	0	266,667	530,667	—	—	—	—	—	—	$ —
	4/30/2018	—	—	—	0	14,572	14,572	—	—	—	$ 393,2
	7/28/2018	—	—	—	—	—	—	13,987	—	—	$ 618,3
	7/28/2018	—	—	—	—	—	—	—	15,988	$ 44.21	$ 428,3
Mark Jenkins	4/30/2018	0	250,000	497,500	—	—	—	—	—	—	$ —
	4/30/2018	—	—	—	0	13,662	13,662	—	—	—	$ 358,0
	7/28/2018	—	—	—	—	—	—	13,113	—	—	$ 579,7
	7/28/2018	—	—	—	—	—	—	—	14,989	$ 44.21	$ 401,5
	9/13/2018(4)	—	—	—	—	—	—	165	—	—	$ 10,5
Benjamin Huston	4/30/2018	0	250,000	497,500	—	—	—	—	—	—	$ —
	4/30/2018	—	—	—	0	13,662	13,662	—	—	—	$ 358,0
	7/28/2018	—	—	—	—	—	—	13,113	—	—	$ 579,7
	7/28/2018	—	—	—	—	—	—	—	14,989	$ 44.21	$ 401,5
	9/13/2018(4)	—	—	—	—	—	—	165	—	—	$ 10,5
Ryan Keeton	4/30/2018	0	220,000	437,800	—	—	—	—	—	—	$ —
	4/30/2018	—	—	—	0	12,022	12,022	—	—	—	$ 315,0
	7/28/2018	—	—	—	—	—	—	11,540	—	—	$ 510,1
	7/28/2018	—	—	—	—	—	—	—	13,190	$ 44.21	$ 353,3
	9/13/2018(4)	—	—	—	—	—	—	165	—	—	$ 10,5
Daniel Gill	4/30/2018	0	220,000	437,800	—	—	—	—	—	—	$ —
	4/30/2018	—	—	—	0	12,022	12,022	—	—	—	$ 315,0
	7/28/2018	—	—	—	—	—	—	11,540	—	—	$ 510,1
	7/28/2018	—	—	—	—	—	—	—	13,190	$ 44.21	$ 353,3
	9/13/2018(4)	—	—	—	—	—	—	165	—	—	$ 10,5

(1) The amounts in these columns represent the threshold, target, and maximum payouts for the 2018 annual incentive plan, as described above under "Compensation Discussion and Analysis." Actual payouts are reflected in the "Summary Compensation Table."

(2) The amounts in these columns represent the number of shares that would be issued upon vesting of the RSUs granted under the 2018 special performance-contingent grant upon achievement of the EBITDA performance target, as described above under "Compensation Discussion and Analysis."

(3) The amounts reported in this column represent the grant date fair value of the options and RSUs granted to the named executive officers as computed in accordance with Financial Accounting Standards Board Accounting Standards Codification Topic 718.

(4) These grants represent the amount awarded under the 100k Milestone Gift, which was given to all of our employees who were employed as of September 10, 2018, and who met certain employment-tenure requirements. See "Compensation Discussion and Analysis – 2018 100k Milestone Gift" for more information.

OUTSTANDING EQUITY AWARDS AT 2018 FISCAL YEAR END

	OPTION AWARDS				EQUITY AWARDS			
NAME	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS (#) EXERCISABLE	NUMBER OF SECURITIES UNDERLYING UNEXERCISED OPTIONS (#) UNEXERCISABLE	OPTION EXERCISE PRICE ($)	OPTION EXPIRATION DATE	NUMBER OF SHARES OR UNITS OF STOCK THAT HAVE NOT VESTED (#)	MARKET VALUE OF SHARES OR UNITS OF STOCK THAT HAVE NOT VESTED ($) (1)	EQUITY INCENTIVE PLAN AWARDS: NUMBER OF UNEARNED SHARES, UNITS OR OTHER RIGHTS THAT HAVE NOT VESTED (#)	EQUITY INCENTIVE PLAN AWARD MARKET OR PAYOUT VALUE OF UNEARNED SHARES, UNIT OR OTHER RIGHTS THAT HAVE NOT VESTED ($) (1
Ernest Garcia III	—	15,988(8)	44.21	7/28/2028	13,987(9)	457,515	14,572(10)	476,6
Mark Jenkins:	—	14,989(8)	44.21	7/28/2028	13,113(9)	428,926	13,662(10)	446,8
Class B Units (2)	—	—	—	—	116,667	3,052,942	—	—
Class B Units (3)	—	—	—	—	50,000	1,064,500	—	—
Class B Units (4)	—	—	—	—	15,000	319,350	—	—
Class B Units (5)	—	—	—	—	41,667	848,198	—	—
Class B Units (6)	—	—	—	—	126,667	1,794,618	—	—
Benjamin Huston:	—	14,989(8)	44.21	7/28/2028	13,113(9)	428,926	13,662(10)	446,8
Class B Units (3)	—	—	—	—	50,000	1,064,500	—	—
Class B Units (4)	—	—	—	—	15,000	319,350	—	—
Class B Units (5)	—	—	—	—	41,667	848,198	—	—
Class B Units (6)	—	—	—	—	126,667	1,794,618	—	—
Ryan Keeton:		13,190(8)	44.21	7/28/2028	11,540(9)	377,473	12,022(10)	393,2
Class B Units (3)	—	—	—	—	25,000	532,250	—	—
Class B Units (4)	—	—	—	—	7,500	159,675	—	—
Class B Units (5)	—	—	—	—	10,417	212,048	—	—
Class B Units (6)	—	—	—	—	47,500	672,980	—	—
Daniel Gill:	—	13,190(8)	44.21	7/28/2028	11,540(9)	377,473	12,022(10)	393,2
Class B Units (7)	—	—	—	—	200,000	5,233,600	—	—
Class B Units (4)	—	—	—	—	10,667	227,093	—	—
Class B Units (5)	—	—	—	—	10,417	212,048	—	—
Class B Units (6)	—	—	—	—	47,500	672,980	—	—

(1) Amounts were determined based on the closing price of Carvana Co.'s Class A common stock on December 31, 2018, of $32.71 and the applicable participation thresholds of our B1 Units (as defined below), B2 Units (as defined below), B3 Units (as defined below) and B4 Units (as defined below). These values may not reflect the value actually realized by the named executive officers upon vesting.

(2) These Class B Units (the "B1 Units") were granted on March 24, 2015, with a participation threshold of $0.00; 200,000 of which vested on July 1, 2015, and 16,667 of which vest on the first of each month beginning on August 1, 2015.

(3) These Class B Units (the "B2 Units") were granted on March 24, 2015, with a participation threshold of $4.878; 20% vested on March 1, 2016, and the remaining amount vests in 48 equal monthly installments on the first of each month thereafter.

(4) These B2 Units were granted on January 29, 2016, with a participation threshold of $4.878; 20% vested on March 1, 2016, and the remaining amount vests in 48 equal monthly installments on the first of each month thereafter.

(5) These Class B Units (the "B3 Units") were granted on October 21, 2016, with a participation threshold of $5.8114; 20% vested on January 1, 2017, and the remaining amount vests in 48 equal monthly installments on the first of each month thereafter.

(6) These Class B Units (the "B4 Units") were granted on April 27, 2017, with a participation threshold of $12.000; 20% vest on February 1, 2018, and the remaining amount vests in 48 equal monthly installments on the first of each month thereafter.

(7) These B1 Units were granted on March 24, 2015, with a participation threshold of $0.00; 20% vested on March 1, 2016, and the remaining amount vests in 48 equal monthly installments on the first of each month thereafter.

(8) These options vest 25% on April 1, 2019, and the remaining amount vests in 36 equal monthly installments on the first of each month thereafter.

(9) These RSUs vest 25% on April 1, 2019, and the remaining amount vests in 36 equal monthly installments on the first of each month thereafter.

(10) These performance-contingent RSUs vest on the date Carvana files a periodic report (i.e., Form 10-Q or Form 10-K) with the SEC reflecting positive EBITDA for a calendar quarter.

OPTION EXERCISES AND STOCK VESTED

NAME	OPTION AWARDS		STOCK AWARDS [1]	
	NUMBER OF SHARES ACQUIRED ON EXERCISE (#)	VALUE REALIZED ON EXERCISE ($)	NUMBER OF SHARES ACQUIRED ON VESTING (#)	VALUE REALIZED ON VESTING ($)
Ernest Garcia III	—	—	—	—
Mark Jenkins	—	—	226,384	8,197,217
Benjamin Huston	—	—	226,384	8,197,217
Ryan Keeton	—	—	107,624	3,894,768
Daniel Gill	—	—	144,152	5,186,740

(1) Amounts include restricted stock units and Class B Units. The number of shares and values were determined based on the closing price of Carvana Co.'s Class A common stock on each vesting date and, in the case of Class B Units, the applicable participation thresholds of our B1 Units, B2 Units, B3 Units, and B4 Units (all as defined above in the "Outstanding Equity Awards at 2018 Fiscal Year End" table).

POTENTIAL PAYMENTS UPON A CHANGE OF CONTROL

As described in "Compensation Discussion and Analysis – Termination, Severance, and Change of Control Benefits" above, we do not have an employment or severance agreement with any of our named executives; however, our NEOs would be entitled to accelerated vesting of certain equity awards under the following conditions, with values listed as of December 31, 2018:

NAME	CHANGE OF CONTROL ($) (1)	INVOLUNTARY TERMINATION WITHOUT CAUSE WITHIN 24 MONTHS OF A CHANGE OF CONTROL ($) (2)
Ernest Garcia III	—	457,515
Mark Jenkins:	7,079,609	428,926
Benjamin Huston:	4,026,667	428,926
Ryan Keeton:	1,576,953	377,473
Daniel Gill:	6,345,721	377,473

(1) Amounts in this column represent the market value as of December 31, 2018, on a fully exchanged basis, of the Class B Units, described above under "Outstanding Equity Awards at 2018 Fiscal Year End," that would vest upon a change of control of Carvana Group, as long as the executive's employment had not been previously terminated and subject to certain escrow demand rights held by a purchaser of control of Carvana Group. The performance-contingent RSUs would also vest on a change of control, but in proportion to the progress made toward positive EBITDA. None of the performance-contingent restricted stock units would be subject to accelerated vesting as of December 31, 2018, because EBITDA as of that date had not progressed beyond the baseline.

(2) Amounts in this column represent the market value as of December 31, 2018, of all outstanding time-based RSUs, which would become fully vested if the executive is involuntarily terminated without cause within 24 months of a change of control of Carvana Co. In that event, outstanding unvested stock options would also become fully vested and exercisable, but as of December 31, 2018, the price of Carvana's Class A common stock did not exceed the strike price of those unvested options.

In connection with the issuance of our senior notes (see Carvana's Annual Report on Form 10-K for 2018, page 66–67), Carvana Group amended its LLC agreement to create a class of non-convertible preferred units, which Carvana Co. purchased with its net proceeds from the issuance of these senior notes.

The operations of Carvana Group, and the rights and obligations of the holders of our LLC Units (who we refer to as "LLC Unitholders"), are set forth in the LLC Operating Agreement.

EXCHANGE AGREEMENT

On April 27, 2017, we entered into an exchange agreement with Carvana Co. Sub LLC (our wholly owned subsidiary) and the LLC Unitholders. Under the exchange agreement, LLC Unitholders (and certain permitted transferees thereof) may exchange at any time their LLC Units for either shares of our Class A common stock or for cash, whichever we decide. To the extent LLC Unitholders also hold Class B common stock, they will be required to deliver to us the same number of shares of Class B common stock as Class A common stock being exchanged for. We will then cancel those shares of Class B common stock. As LLC Unitholders exchange their interest in Carvana Group, our indirect interest in Carvana Group will increase correspondingly.

When an LLC Unitholder makes an exchange, they will receive four shares of Class A common stock for every five Class A Units or, at our option, cash equal to the value of a share of Class A common stock multiplied by 0.8 times the number of Class A Units being exchanged. The value of the Class A common stock is determined by the average of the volume-weighted average prices for a share of Class A common stock for each of the three consecutive full trading days ending on and including the last full trading day immediately prior to the related date of exchange. Class B Units are subject to vesting and a participation threshold, and, as a result, LLC Unitholders exchanging Class B Units will receive a number of shares of Class A common stock equal to the Class A common stock value (determined the same way as above) less the applicable participation threshold multiplied by 0.8 times the number of Class B Units being exchanged, divided by the same Class A common stock value, subject to adjustment as set forth in the Exchange Agreement.

REGISTRATION R IGHTS AGREEMENT

In connection with the IPO, we entered into a registration rights agreement with certain LLC unitholders. These LLC unitholders are entitled to request that we register their shares on a long-form or short-form registration statement on one or more occasions in the future, which registrations may be "shelf registrations." All of these LLC unitholders will be entitled to participate in certain of our registered offerings, subject to the restrictions in the registration rights agreement. We will pay expenses in connection with the exercise of these rights. The registration rights described in this paragraph apply to (1) shares of our Class A common stock held by certain LLC unitholders, and (2) any of our capital stock (or that of our subsidiaries) issued or issuable with respect to the Class A common stock described in clause (1) with respect to any dividend, stock split, recapitalization, reorganization, or certain other corporate transactions ("Registrable Securities"). These registration rights are also for the benefit of any subsequent holder of Registrable Securities, provided that any particular securities will cease to be Registrable Securities when they have been sold in a registered public offering, sold in compliance with Rule 144 of the Securities Act or repurchased by us or our subsidiaries. In addition, any Registrable Securities held by a person other than an LLC Unitholder and their affiliates will cease to be Registrable Securities if they can be sold without limitation under Rule 144 of the Securities Act.

TAX RECEIVABLE AGREEMENT

We have entered into a Tax Receivable Agreement with LLC Unitholders that will provide for the payment from time to time by us to such persons of 85% of the amount of the benefits, if any, that we realize or, under certain circumstances, are deemed to realize as a result of

1. the increase in our wholly owned subsidiary's proportionate share of the existing tax basis of the assets of Carvana Group and an adjustment in the tax basis of the assets of Carvana Group reflected in that proportionate share as a result of any future exchanges of LLC Units held by an LLC Unitholder for shares of our Class A common stock or cash, and
2. certain other tax benefits related to our making payments under the Tax Receivable Agreement.

We expect to benefit from the remaining 15% of any tax benefits that we actually realize and, except in connection with a change in control, we will not make any payments under the Tax Receivable Agreement until after we have directly or indirectly realized (or have been deemed to have realized) benefits in excess of such payments. These payment obligations are obligations of Carvana Co. and not of Carvana Group. No payments were made during the year ended December 31, 2018.

INDEMNIFICATION OF OFFICERS AND DIRECTORS

We have entered into indemnification agreements with each of our officers and directors. The indemnification agreements provide the officers and directors with contractual rights to indemnification, expense advancement, and reimbursement, to the fullest extent permitted under Delaware law. Additionally, we may enter into indemnification agreements with any new directors or officers that may be broader in scope than the specific indemnification provisions contained in Delaware law.

CONTRIBUTION AGREEMENTS

On September 10, 2018, we announced a commitment by our chief executive officer, Ernest Garcia III, to contribute shares of Carvana Co. Class A common stock from his personal shareholdings to Carvana at no charge, intended to fund equity awards of 165 restricted stock units (or roughly $10,000 at the time of the announcement) to each of our then-current employees upon their satisfying certain employment-tenure requirements. During the year ended December 31, 2018, Carvana and Mr. Garcia entered into contribution agreements pursuant to which Mr. Garcia contributed approximately 0.2 million shares of Carvana Co. Class A common stock to Carvana, at no charge. We subsequently granted approximately 0.2 million restricted stock units. Although we do not expect Mr. Garcia to incur any tax obligations related to these contributions, we have indemnified Mr. Garcia from any such obligations that may arise.

RELATIONSHIP WITH DRIVETIME

Prior to November 1, 2014, Carvana, LLC was a wholly owned subsidiary of DriveTime. On November 1, 2014, DriveTime distributed the units of Carvana, LLC to the unit holders of DriveTime on a pro rata basis, which we refer to as the “Spinoff.” DriveTime is controlled by our controlling stockholder, Ernest Garcia II, who is also the father of our Chief Executive Officer, Ernest Garcia III. Following the Spinoff, the unitholders of DriveTime contributed the Carvana, LLC units to Carvana Group.

Subsequent to the Spinoff, we entered into several agreements with DriveTime and affiliated companies that were intended to facilitate our transition to a standalone company, which are described below, along with subsequent agreements. We will refer to DriveTime and its subsidiaries and affiliates, other than us, as “DriveTime”. There can be no assurances that DriveTime or its affiliated companies will enter into any new agreements or arrangements with us, or extend or renew existing agreements or arrangements, on the same terms, similar terms, or at all.

ATLANTA, GA HUB LOCATION LEASE GUARANTEE

In May 2013, DriveTime guaranteed our obligations under the lease governing our occupancy of the property on which an Atlanta hub is located. We do not compensate DriveTime for the guarantee. The initial lease term and rent payments commenced December 1, 2013, and the current term expires on November 30, 2019. Under the lease we may enter into one more two-year extension term. Base rent during the initial term was $9.5 thousand per month but may increase by 3% of the then-current base rent during each extension term. Monthly rent payments for January 1, 2018, through November 30, 2018, were $10.4 thousand per month, and as of December 1, 2018, are $10.7 thousand per month through November 30, 2019. In addition to base rent, we are responsible for our proportionate share of common area maintenance charges.

LEASE AGREEMENT

In connection with the Spinoff, we entered into a lease agreement dated November 1, 2014, with DriveTime that governs our access to and utilization of space at DriveTime inspection and reconditioning centers ("IRCs") for vehicle inspection and reconditioning in Blue Mound, Texas, and Delanco, New Jersey, and previously for inspection and reconditioning in Winder, Georgia. The lease agreement was most recently amended in December 2018. The agreement also governs utilization of office space and parking spaces at various IRCs and retail facilities that we use as hubs.

Under the amended lease agreement, hubs generally have cancellable two-year terms subject to certain two consecutive one-year renewal options and subject to the terms of any master lease under which we are subleasing. We increased our utilization of the DriveTime IRCs in Blue Mound, Texas, and Delanco, New Jersey, to 100% as of July 2018. Under the lease agreement, we pay a monthly rental fee related to our pro rata utilization of space at such facilities plus a pro rata share of each facility's actual insurance costs and real estate taxes. As it relates to locations where we recondition vehicles, our share of facility and reconditioning-supplies expenses are calculated monthly by multiplying the actual costs for operating the inspection centers by an amount related to our pro rata share of total reconditioned vehicles and parking spaces used at such IRCs in a given month. Total expenses related to this lease agreement were approximately $5.1 million for the year ended December 31, 2018.

HOUSTON, TX VENDING MACHINE LEASE GUARANTEE

On July 14, 2015, DriveTime guaranteed our obligations under the lease governing our occupancy of the property on which our Houston vending machine is located. We do not compensate DriveTime for the guarantee. The initial lease term commenced January 8, 2016, and we began paying base rent on May 7, 2016. Base rent during the initial term is $23.0 thousand per month, and the initial term expires on April 6, 2026. We have the option to extend the initial term for four additional consecutive five-year periods. Base rent during each extension term will increase 10% of the then-current base rent for each subsequent extension.

TEMPE, AZ OFFICE LEASE

In September 2016, we entered into an agreement to lease the second floor of our corporate headquarters in Tempe, Arizona beginning April 2017. Pursuant to this lease, we paid an initial monthly base rent of $107.0 thousand, which increases throughout the duration of the lease. The lease has an initial term of 83 months and we have three 5-year extension options. At the request of the landlord, DriveTime agreed to partially guarantee our lease payments until the 30th full calendar month of the lease. We do not compensate DriveTime for the guarantee.

In connection with this lease, we entered into a sublease with DriveTime for our use of the first floor of the same building. Under the sublease, which is coterminous with DriveTime's master lease and has a term of 83 months, subject to our right to exercise three 5-year extension options, we pay DriveTime rent equal to the amounts due under the master lease, including initial monthly base rent of $102.0 thousand, beginning April 1, 2018, which increases throughout the duration of the sublease and master lease. Total expenses related to this lease agreement were approximately $0.9 million for the year ended December 31, 2018.

TOLLESON, AZ INSPECTION AND RECONDITIONING CENTER LEASE

In December 2016, we entered into a lease agreement with Verde Investments Inc. ("Verde"), an affiliate of DriveTime, for an IRC in Tolleson, Arizona. The lease commenced in February, 2017. In August 2018, we entered into an additional lease agreement with a coterminous initial term with Verde for contiguous space to use in connection with such center, which began that same month. The leases expire in December 2031 subject to our right to extend for four 5-year terms. Pursuant to the leases, we pay an initial base rent of $137.5 thousand per month, which is adjusted each year beginning on January 1, 2018, and $57.1 thousand per month, which is adjusted each year beginning on January 1, 2020, respectively, each in accordance with the Consumer Price Index, subject to a minimum increase of 2% per year and a maximum increase of 5% per year. Total expense related to these lease agreements was approximately $2.2 million for the year ended December 31, 2018.

WINDER, GA INSPECTION AND RECONDITIONING CENTER LEASE

In February 2017, we entered into a lease with DriveTime for an IRC in Winder, Georgia where we have maintained partial occupancy previously under the DriveTime lease agreement described above. We are now the sole occupant. The lease has an 8-year term, subject to our ability to exercise three renewal option terms of five years each. We began paying base rent of $83.3 thousand per month as of March 1, 2017. The monthly rent is subject to adjustment each year beginning January 1, 2018, increasing in an amount equal to the percentage increase in the Consumer Price Index, with a maximum of 5% and a minimum of 2%. The monthly rent increased on January 1, 2018, to $85.1 thousand. Our total expenses related to this lease agreement were approximately $1.1 million for the year ended December 31, 2018.

HUB LEASE AGREEMENT

In March 2017, we entered into a lease with DriveTime that governs our utilization of office space and parking spaces at retail facilities that we use as hubs. The lease was most recently amended in December 2018. Under the lease agreement, we pay a monthly rental fee related to our pro rata utilization of space at such facilities plus a pro rata share of each facility's actual insurance costs and real estate taxes. Each hub has an initial cancellable term of two years, subject to certain two consecutive one-year renewal options. Our total expenses related to this lease agreement were approximately $0.4 million for the year ended December 31, 2018.

CLEVELAND, OH AREA INSPECTION AND RECONDITIONING CENTER SUBLEASE

In November 2018, Carvana entered into a sublease agreement with DriveTime for an inspection and reconditioning center near Cleveland, Ohio. Pursuant to the sublease, Carvana temporarily shared space at the IRC until DriveTime vacated the facility in February 2019, at which point we purchased certain leasehold improvements and equipment at the facility from DriveTime for approximately $4.3 million (which amount represented the book value of such improvements and equipment net of accumulated depreciation and amortization) and became the sole occupant. We pay a base rent of $35.0 thousand per month which increases in each extension term. The sublease has an initial term of three years. We have the ability to exercise three renewal options of five years each. Before DriveTime vacated the property, we paid a monthly rental fee related to our pro rata utilization of space at the facility plus a pro rata share of the facility's actual insurance costs and real estate taxes. Our share of facility and shared reconditioning supplies expenses were calculated based on the actual costs for operating the inspection and reconditioning center and our pro rata share of total reconditioned vehicles and parking spaces at the IRC in a given month. Our total expenses related to this lease agreement were $29.4 thousand for the year ended December 31, 2018.

NASHVILLE, TN AREA INSPECTION AND RECONDITIONING CENTER LEASE

On February 28, 2019, Carvana assumed a lease from DriveTime of an IRC near Nashville, Tennessee. As part of the agreement, we agreed to purchase certain leasehold improvements and equipment at the facility from DriveTime for approximately $2.0 million (which amount represented the book value of such improvements and equipment net of accumulated depreciation and amortization). The term expires on October 31, 2023, subject to our ability to exercise three renewal options of five years each. DriveTime will remain a partial occupant of the IRC until April 1, 2019 and will not be fully released from lease obligations by the landlord. Beginning April 1, 2019, Carvana will be the sole occupant of the IRC. Base rent during the current term of the lease is $21.0 thousand per month and will increase to between $30.0–$31.0 thousand per month in the second half of 2019, depending on the extent of Carvana's expansion of leased space, and will further increase during each extension term over the then-current base rent by an amount equal to the percentage increase in the Consumer Price Index, with a maximum of 15% and a minimum of 10%.

SERVICING AGREEMENT WITH DRIVETIME

In December 2015, we entered into a servicing agreement with DriveTime, wherein DriveTime agreed to perform certain servicing and administrative functions with respect to automotive finance receivables we own after origination and before sale. In the year ended December 31, 2018, DriveTime had aggregate earnings of approximately $0.9 million for performing servicing functions for such receivables.

MASTER PURCHASE AND SALE AGREEMENT

In December 2016, we entered into a master purchase and sale agreement pursuant to which we sell finance receivables meeting certain underwriting criteria to certain financing partners, including Ally Bank and Ally Financial (collectively, "Ally"). On November 3, 2017, we amended this agreement to increase the aggregate amount of principal balances of finance receivables we can sell to $1.5 billion. We amended the agreement again on November 2, 2018 to, among other things and subject to the terms of the agreement, increase the purchase commitment to up to a maximum of $1.25 billion of additional principal balances of finance receivables during the remaining term of the agreement.

During the year ended December 31, 2018, we sold approximately $733.4 million in principal balances of finance receivables under the purchase and sale agreement. As of December 31, 2018, there was approximately $1.1 billion of unused capacity under this agreement. The agreement was most recently amended on January 4, 2019.

The financing partners have engaged DriveTime as servicer of the receivables purchased under this agreement. DriveTime had aggregate earnings of $3.1 million pursuant to the agreement for performing servicing functions for the year ended December 31, 2018.

MASTER TRANSFER AGREEMENTS

In December 2016, we entered into a master transfer agreement pursuant to which we sell finance receivables meeting certain underwriting criteria to certain financing partners (the "2016 Master Transfer Agreement"). Under the agreement, the purchaser trust agreed to purchase up to an aggregate of $292.2 million in principal balances of finance receivables. In November 2017, we terminated the remaining capacity under the 2016 Master Transfer Agreement and replaced this facility by entering into a new master transfer agreement pursuant to which we sell finance receivables meeting certain underwriting criteria to certain financing partners (the "2017 Master Transfer Agreement"). Under the agreement, the purchaser trust agreed to purchase up to an aggregate of $357.1 million in principal balances of finance receivables.

On November 2, 2018, we amended the 2017 Master Transfer Agreement to, among other things and subject to the terms of the agreement, increase and extend the trust's commitment to purchase finance receivables from us. The trust's currently available financing following the amendment permits up to $454.5 million in principal balances of finance receivables to be purchased, and the 2017 Master Transfer Agreement's purchase commitment contemplates the trust securing up to three times the currently available financing in the aggregate.

During the year ended December 31, 2018, we sold approximately $348.8 million in principal balances of finance receivables under the 2017 Master Transfer Agreement prior to the amendment in November, excluding those that were part of the refinancing transactions described below under "Refinancing Transfer Agreements". As of December 31, 2018, there was approximately $454.5 million of unused capacity under 2017 Master Transfer Agreement. During the year ended December 31, 2017, Carvana sold an aggregate of approximately $163.7 million in principal balances of finance receivables under the 2016 Master Transfer Agreement and 2017 Master Transfer Agreement.

The purchasers engaged Carvana as the administrator of the trust and DriveTime as servicer of the receivables. In the year ended December 31, 2018, we had aggregate earnings of $4.0 thousand for performing trust administrator functions for the purchasers and DriveTime had aggregate earnings of $4.0 million for performing servicing functions.

REFINANCING TRANSFER AGREEMENTS

On August 6, 2018, in connection with a refinancing transaction, we purchased finance receivables we had previously sold under the 2017 Master Transfer Agreement and simultaneously entered into a transfer agreement with a purchaser trust under which the trust immediately purchased such finance receivables from us. On December 21, 2018, in connection with another refinancing transaction, we purchased finance receivables we had previously sold under the 2017 Master Transfer Agreement and simultaneously entered into another transfer agreement with a purchaser trust under which the trust purchased such finance receivables and other finances receivables from us. During the year ended December 31, 2018, we sold approximately $477.9 million in principal balances of finance receivables under these transfer agreements.

The trusts engaged Carvana as the administrator of the trust and DriveTime as servicer of the receivables. In the year ended December 31, 2018, we had aggregate earnings of $0.0 thousand for performing trust administrator functions for the purchasers and DriveTime had aggregate earnings of $1.5 million for performing servicing functions.

MASTER DEALER AGREEMENT

In December 2016, we entered into a master dealer agreement with DriveTime. Pursuant to this agreement, we may sell vehicle service contracts ("VSCs") to customers purchasing a vehicle from us. We earn a commission on each VSC sold to our customers and DriveTime is obligated by and subsequently administers the VSCs. We collect the retail purchase price of the VSCs from our customers and remit the purchase price net of commission to DriveTime. During the year ended December 31, 2018, we recognized approximately $23.7 million of commissions earned on VSCs sold to our customers and administered by DriveTime, net of a reserve for estimated contract cancellations. On November 5, 2018 (effective October 1, 2018), we amended the master dealer agreement to allow Carvana to receive payments for excess reserves based on the performance of the VSCs versus the reserves held by the VSC administrator, once a required claims period for such VSCs has passed. During the year ended December 31, 2018, Carvana recognized approximately $1.9 million related to payments for excess reserves to which it expects to be entitled.

Beginning in 2017, DriveTime also administers a portion of our GAP waiver coverage and the limited warranty provided to all customers under the master dealer agreement. We pay a per-contract fee to DriveTime to administer a portion of the GAP waiver coverage we sell to our customers and a per-vehicle fee to DriveTime to administer the limited warranty included with every purchase. We incurred costs of approximately $2.2 million during the year ended December 31, 2018, related to the administration of GAP waiver coverage and limited warranty.

IP LICENSE AGREEMENT

In February 2017, we entered into a license agreement that governs the rights of certain intellectual property owned by us and the rights of certain intellectual property owned by DriveTime. The license agreement, which was amended and restated on April 14, 2017, generally provides that each party grants to the other certain limited exclusive (other than with respect to the licensor party and its affiliates) and nonexclusive licenses to use certain of its intellectual property, and each party agrees to certain covenants not to sue the other party, its affiliates and certain of its service providers in connection with various patent claims. The exclusive license to DriveTime is limited to the business that is primarily of sub-prime used car sales to retail customers. However, upon a change of control of either party, both parties' license rights as to certain future improvements to licensed intellectual property and all limited exclusivity rights are terminated. The agreement does not provide a license to any of our patents, trademarks, logos, customers' personally identifiable information or any intellectual property related to our vending machine, automated vehicle photography or certain other elements of our brand.

AIRCRAFT TIME SHARING AGREEMENT

On October 22, 2015, we entered into an agreement, which was amended on May 15, 2017, to share usage of two aircraft operated by DriveTime. Pursuant to the agreement, we agreed to reimburse DriveTime for actual expenses for each of our flights. The original term of the agreement was for 12 months, with perpetual 12-month automatic renewals. Either the lessors or the lessees can terminate the lease with 30 days' written notice. We reimbursed DriveTime $0.5 million under this agreement during the year ended December 31, 2018.

UNSECURED SENIOR NOTES

In September 2018, we issued an aggregate of $350.0 million in senior unsecured notes due 2023. The senior notes accrue interest at a rate of 8.875% per annum, which is payable semi-annually in arrears on April 1 and October 1 of each year beginning April 1, 2019. Verde Investments, Inc., an affiliate of DriveTime, purchased notes reflecting $25.0 million of outstanding principal and subsequently sold a portion. As of December 31, 2018, Verde held $15.0 million of principal of the notes.

SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

The following table sets forth information regarding beneficial ownership of our common stock as of February 27, 2019, by:

- each person or group of affiliated persons known by us to be the beneficial owner of more than 5% of our common stock,
- each of our named executive officers,
- each of our directors, and
- all of our current executive officers and directors as a group.

We have determined beneficial ownership in accordance with the rules of the SEC, and the information is not necessarily indicative of beneficial ownership for any other purpose. Unless otherwise indicated below, it is our understanding that the persons and entities named in the table have sole voting and sole investment power with respect to all shares that they beneficially own, subject to community property laws where applicable. In computing the number of shares of our common stock beneficially owned by a person and the percentage ownership of that person, we deemed outstanding shares of our common stock subject to options, Class B Units, or restricted stock units held by that person that are currently exercisable or exercisable within 60 days of February 27, 2019. We did not deem these shares outstanding, however, for the purpose of computing the percentage ownership of any other person. We have based the percentage ownership of our Class A common stock on 41,201,324 shares of our common stock outstanding as of February 27, 2019, and have based the percentage ownership of our Class B common stock on 104,336,303 shares as of the same date. Unless otherwise indicated, the address of each beneficial owner listed on the table below is c/o Carvana Co., 1930 W Rio Salado Pkwy, Tempe, AZ 85281.

	SHARES BENEFICIALLY OWNED				
	CLASS A COMMON STOCK (1)		CLASS B COMMON STOCK (1)		
NAME OF BENEFICIAL OWNER	SHARES	%	SHARES	%	VOTING %
Ernest C. Garcia II c/o Verde Investments, Inc.	1,578,208(2)	4%	87,701,897(3)	84%	91%
Spruce House Investment Management LLC; Spruce House Capital LLC; Spruce House Partnership LP; Zachary Sternberg; Benjamin Stein	5,600,000(4)	14%	—	—%	*
Melvin Capital Management LP; Melvin Capital Master Fund Ltd	3,725,000(5)	9%	—	—%	*
FMR LLC	3,591,784(6)	9%	—	—%	*
The Vanguard Group	2,954,186(7)	7%	—	—%	*
Nantahala Capital Management, LLC; Wilmot B. Harkey; Daniel Mack	2,329,714(8)	5%	—	—%	*
CAS Investment Partners, LLC; Sosin Partners, L.P.; Clifford Sosin	2,194,504(9)	5%	—	—%	*
Blackrock, Inc.	2,104,793(10)	5%	—	—%	*
Executive Officers and Directors					
Ernest Garcia, III	93,060(11)	*	15,616,526(12)	15%	16%
Mark Jenkins	876,676(13)	2%	—	—%	*
Benjamin Huston	916,676(14)	2%	—	—%	*
Daniel Gill	468,253(15)	1%	—	—%	*
Ryan Keeton	417,269(16)	1%	—	—%	*
Ira Platt	173,786(17)	*	130,612*		*
Gregory Sullivan	20,619(18)	*	—	—%	*
Dan Quayle	20,619(18)	*	—	—%	*
Michael Maroone	71,619(19)	*	—	—%	*
All executive officers and directors (10 individuals)	3,203,895(20)	8%	15,747,138	15%	16%

(1) Each share of Class A common stock entitles the registered holder thereof to one vote on all matters presented to stockholders for a vote generally, including the election of directors. Each share of our Class B common stock held by the Garcia Parties entitles its holder to ten votes on all matters to be voted on by stockholders generally, including the election of directors, for so long as the Garcia Parties maintain, in the aggregate, direct or indirect beneficial ownership of at least 25% of the outstanding shares of Class A common stock (determined on an as-exchanged basis assuming that all of the LLC Units were exchanged for Class A common stock). Each other share of our Class B common stock entitles its holder to one vote on all matters to be voted on by stockholders generally, including the election of directors. The Class A common stock and Class B common stock vote as a single class on all matters except as required by law or the certificate of incorporation. A "*" indicates percentages of less than 1%.

(2) This number includes 1,464,517 shares of our Class A common stock that Mr. Garcia II purchased through Verde Investments, Inc. ("Verde"), of which Mr. Garcia II is the 100% owner. This number also includes 13,691 shares of our Class A common stock owned by the Ernest Irrevocable 2004 Trust III and 100,000 shares of our Class A common stock owned by the Ernest C. Garcia III Multi-Generational Trust III. While Ernest Garcia II is the investment trustee over Ernest C. Garcia III Multi-Generational Trust III, the trust is irrevocable and he is not a beneficiary. While Ernest Garcia II and Ernest Garcia III are the joint investment trustees over Ernest Irrevocable 2004 Trust III, the trust is irrevocable and Mr. Garcia II is not a beneficiary. Mr. Garcia III is the

sole beneficiary of the Ernest Irrevocable 2004 Trust III and Mr. Garcia III and his children are the beneficiaries of the Ernest C. Garcia III Multi-Generational Trust III. This information is based on the Form 4 filed with the SEC by Mr. Garcia II on February 27, 2019. Verde's and Mr. Garcia II's address is 1720 W. Rio Salado Parkway, Suite A, Tempe, AZ 85281.

(3) This number includes 52,937,458 shares of Class B common stock owned directly by Mr. Garcia II; 8,000,000 shares of Class B common stock owned by ECG III SPE, of which Mr. Garcia II is the 100% owner; 2,860,439 shares of Class B common stock owned by DriveTime Sales and Finance Company LLC. Mr. Garcia II is the chairman of the board of directors and largest stockholder of DriveTime, of which DriveTime Sales and Finance Company LLC is a wholly owned subsidiary. This number also includes 11,952,000 shares of Class B common stock owned by the Ernest Irrevocable 2004 Trust III, of which Mr. Garcia III is the sole beneficiary, and 11,952,000 shares of Class B common stock owned by the Ernest C. Garcia III Multi-Generational Trust III, of which Mr. Garcia III is a beneficiary together with his children. While Ernest Garcia II is the investment trustee over Ernest C. Garcia III Multi-Generational Trust III, the trust is irrevocable and he is not a beneficiary. While Ernest Garcia II and Ernest Garcia III are the joint investment trustees over Ernest Irrevocable 2004 Trust III, the trust is irrevocable and Mr. Garcia II is not a beneficiary. These shares of Class B common stock together with the corresponding LLC Units may be exchanged for 87,701,897 shares of Class A common stock. These shares of Class A common stock represent approximately 58% of the shares of Class A common stock that would be outstanding if all outstanding LLC Units were exchanged and all outstanding shares of Class B common stock were converted at that time. This information is based on the Form 4 filed with the SEC by Mr. Garcia II on February 27, 2019. Verde's, ECG III SPE's, and Mr. Garcia II's address is 1720 W. Rio Salado Parkway, Suite A, Tempe, AZ 85281.

(4) Spruce House Investment Management LLC; Spruce House Capital LLC; Spruce House Partnership LP; Zachary Sternberg and Benjamin Stein report shared voting and dispositive power of 5,500,000 shares of Class A common stock. Zachary Sternberg and Benjamin Stein each report sole voting and dispositive power of 50,000 shares of Class A common stock. Spruce House Partnership LP holds the 5,500,000 shares with shared voting and dispositive power and Spruce House Capital LLC serves as the general partner and Spruce House Investment Management LLC serves as the investment manager. Zachary Sternberg and Benjamin Stein each serve as a managing member of the Spruce House Capital LLC and the Spruce House Investment Management LLC. This information is based on the Schedule 13G/A filed with the SEC on February 14, 2019. The address for each of these reporting persons is 435 Hudson Street, 8th Floor New York, NY 10014.

(5) Melvin Capital Management LP is the investment manager of Melvin Capital Master Fund Ltd. Melvin Capital Management LP reports shared voting and dispositive power of 3,725,000 shares of Class A common stock. The number of shares reported above consists of 1,606,827 shares of Class A common stock and call options exercisable into 861,600 shares of Class A common stock held by Melvin Capital Master Fund Ltd; 300,909 shares of Class A common stock and call options exercisable into 161,200 shares of Class A common stock held by Melvin Capital Onshore LP; and 517,264 shares of Class A common stock and call options exercisable into 277,200 shares of Class A common stock held by one or more managed accounts. Melvin Capital Management LP, as the investment manager to these funds and accounts, may be deemed to beneficially own the 2,425,000 shares of Common Stock and the call options exercisable into 1,300,000 shares of Class A common stock held by them. This information is based on the Schedule 13G/A filed with the SEC on February 15, 2019. The address for each of these reporting persons is 527 Madison Avenue, 25th Floor, New York, NY 10022.

(6) FMR LLC reports sole power to dispose or direct the disposition of 3,591,784 shares of Class A common stock. This information is based on the Schedule 13G filed with the SEC on February 14, 2019. FMR LLC's address is 245 Summer Street, Boston, MA 02210.

(7) The Vanguard Group reports shared power to dispose or direct the disposition of 63,700 of these shares of Class A common stock. This information is based on the Schedule 13G filed with the SEC on February 11, 2019. The Vanguard Group's address is 100 Vanguard Blvd., Malvern, PA 19355.

(8) Wilmot B. Harkey and Daniel Mack are the managing members of Nantahala Capital Management, LLC and together report shared voting and dispositive power with respect to these shares. This number of shares includes call options exercisable into 1,450,000 shares of Class A common stock. This information is based on the Schedule 13G filed with the SEC on February 14, 2019. The address for each of these reporting persons is 19 Old Kings Highway S, Suite 200 Darien, CT 06820.

(9) CAS Investment Partners, LLC, Sosin Partners, L.P., and Clifford Sosin report shared voting and dispositive power with respect to 2,167,766 of these shares and Mr. Sosin reports sole voting and dispositive power with respect to 26,738 of these shares. Sosin Partners, L.P. owns an aggregate of 2,167,766 shares of Class A common stock and CAS Investment Partners, LLC,

is the investment manager of the fund. As a result, CAS Investment Partners, LLC, possesses the power to vote and dispose or direct the disposition of all the shares owned by the fund. Thus, CAS Investment Partners, LLC, may be deemed to beneficially own a total of 2,167,766 shares. Mr. Sosin is the managing member of CAS Investment Partners, LLC. As a result, Mr. Sosin possesses the power to vote and dispose or direct the disposition of all the shares beneficially owned by CAS Investment Partners, LLC as investment manager of Sosin Partners, L.P. Mr. Sosin disclaims beneficial ownership of any of the shares held by Sosin Partners, L.P. This information is based on the Schedule 13G/A filed with the SEC on February 14, 2019. The address for each of these reporting persons is 8 Wright Street, 1st FL Westport, CT 06880.

(10) Blackrock, Inc. reports sole power to dispose or direct the disposition of these shares of Class A common stock. This information is based on the Schedule 13G filed with the SEC on February 8, 2019. Blackrock, Inc.'s address is 55 East 52nd Street, New York, NY 10055.

(11) This number includes 71,875 shares of Class A common stock owned directly by Ernest Garcia III, and 13,691 shares of our Class A common stock owned by the Ernest Irrevocable 2004 Trust III. While Ernest Garcia II and Ernest Garcia III are the investment trustees over Ernest Irrevocable 2004 Trust III, the trust is irrevocable and Mr. Garcia II is not a beneficiary. Mr. Garcia III is the sole beneficiary of the Ernest Irrevocable 2004 Trust III. This number also includes 3,997 shares of Class A common stock issuable upon the exercise of options that vest on April 1, 2019, and 3,497 shares of Class A common stock issuable upon the vesting and settlement of restricted stock units that vest on April 1, 2019, inclusive of shares to be withheld for tax purposes. This number excludes 14,572 shares of Class A common stock underlying performance-based RSUs that are subject to vesting on the date that performance objectives are achieved, so long as it is achieved prior to April 27, 2027.

(12) This number includes 3,664,526 shares of Class B common stock owned directly by Mr. Garcia III, and 11,952,000 shares of Class B common stock owned by the Ernest Irrevocable 2004 Trust III, of which Mr. Garcia III is the sole beneficiary. While Ernest Garcia II and Ernest Garcia III are the investment trustees over Ernest Irrevocable 2004 Trust III, the trust is irrevocable and Mr. Garcia II is not a beneficiary. Mr. Garcia III is the sole beneficiary of the Ernest Irrevocable 2004 Trust III. These shares of Class B common stock together with the corresponding LLC Units may be exchanged for 15,616,526 shares of Class A common stock. These shares of Class A common stock represent approximately 10% of the shares of Class A common stock that would be outstanding if all outstanding LLC Units were exchanged and all outstanding shares of Class B common stock were converted at that time.

(13) This number includes 120 shares of Class A common stock owned directly by Mr. Jenkins; 869,531 shares of Class A common stock issuable in exchange for vested Class B Units including those that will be vested within 60 days of February 27, 2019, based on an assumed price of $41.82 per share (the closing price of our Class A common stock on the NYSE on February 27, 2019); 3,747 shares of Class A common stock issuable upon the exercise of options that vest on April 1, 2019; and 3,278 shares of Class A common stock issuable upon the vesting and settlement of restricted stock units that vest on April 1, 2019, inclusive of shares to be withheld for tax purposes. This number excludes 13,662 shares of Class A common stock underlying performance-based RSUs that are subject to vesting on the date that performance objectives are achieved, so long as it is achieved prior to April 27, 2027.

(14) This number includes 120 shares of Class A common stock owned directly by Mr. Huston; 909,531 shares of Class A common stock issuable in exchange for vested Class B Units including those that will be vested within 60 days of February 27, 2019, based on an assumed price of $41.82 per share (the closing price of our Class A common stock on the NYSE on February 27, 2019); 3,747 shares of Class A common stock issuable upon the exercise of options that vest on April 1, 2019; and 3,278 shares of Class A common stock issuable upon the vesting and settlement of restricted stock units that vest on April 1, 2019, inclusive of shares to be withheld for tax purposes. This number excludes 13,662 shares of Class A common stock underlying performance-based RSUs that are subject to vesting on the date that performance objectives are achieved, so long as it is achieved prior to April 27, 2027.

(15) This number includes 120 shares of Class A common stock owned directly by Mr. Gill; 461,950 shares of Class A common stock issuable in exchange for vested Class B Units including those that will be vested within 60 days of February 27, 2019, based on an assumed price of $41.82 per share (the closing price of our Class A common stock on the NYSE on February 27, 2019); 3,298 shares of Class A common stock issuable upon the exercise of options that vest on April 1, 2019; and 2,885 shares of Class A common stock issuable upon the vesting and settlement of restricted stock units that vest on April 1, 2019, inclusive of shares to be withheld for tax purposes. This number excludes 12,022 shares of Class A common stock underlying performance-based RSUs that are subject to vesting on the date that performance objectives are achieved, so long as it is achieved prior to April 27, 2027.

(16) This number includes 6,120 shares of Class A common stock owned directly by Mr. Keeton; 404,966 shares of Class A common stock issuable in exchange for vested Class B Units including those that will be vested within 60 days of February 27, 2019, based on an assumed price of $41.82 per share (the closing price of our Class A common stock on the NYSE on February 27, 2019); 3,298 shares of Class A common stock issuable upon the exercise of options that vest on April 1, 2019; and 2,885 shares of Class A common stock issuable upon the vesting and settlement of restricted stock units that vest on April 1, 2019, inclusive of shares to be withheld for tax purposes. This number excludes 12,022 shares of Class A common stock underlying performance-based RSUs that are subject to vesting on the date that performance objectives are achieved, so long as it is achieved prior to April 27, 2027.

(17) This number includes 20,000 shares of Class A common stock owned directly by Mr. Platt and 2,500 shares of Class A common stock held directly and jointly by Mr. Platt's parents. This number also includes 130,667 shares of Class A common stock issuable in exchange for vested Class B Units including those that will be vested within 60 days of February 27, 2019, based on an assumed price of $41.82 per share (the closing price of our Class A common stock on the NYSE on February 27, 2019); 10,309 options to purchase shares of Class A common stock that vested on April 27, 2018; and 10,310 options to purchase shares of Class A common stock that vest on April 27, 2019. This number excludes 130,612 shares of Class A common stock issuable in exchange for Class B common stock and LLC Units held by Mr. Platt and his dependent son, based on an assumed price of $41.82 per share (the closing price of our Class A common stock on the NYSE on February 27, 2019). These shares of Class A common stock represent less than 1% of the shares of Class A common stock that would be outstanding if all outstanding LLC Units were exchanged and all outstanding shares of Class B common stock were converted at that time.

(18) This number includes 10,309 options to purchase shares of Class A common stock that vested on April 27, 2018, and 10,310 options to purchase shares of Class A common stock that vest on April 27, 2019.

(19) This number includes 30,000 shares of Class A common stock owned directly by Mr. Maroone, 1,000 shares of Class A common stock held directly by the Maroone Family Partnership, LP, an entity controlled by Mr. Maroone that Mr. Maroone disclaims beneficial ownership of except to the extent of his pecuniary interest therein, and 20,000 shares of Class A common stock held directly by the Michael Maroone Family Partnership, LP, an entity controlled by Mr. Maroone. This number also includes 10,309 options to purchase shares of Class A common stock that vested on April 27, 2018, and 10,310 options to purchase shares of Class A common stock that vest on April 27, 2019.

(20) This number includes 2,915,780 shares of Class A common stock issuable in exchange for vested Class B Units including those that will be vested within 60 days of February 27, 2019, based on an assumed price of $41.82 per share (the closing price of our Class A common stock on the NYSE on February 27, 2019); 41,236 options to purchase shares of Class A common stock that vested on April 27, 2018; 41,240 options to purchase shares of Class A common stock that vest on April 27, 2019; 21,385 options to purchase shares of Class A common stock that vest on April 1, 2019; and 18,708 shares of Class A common stock issuable upon the vesting and settlement of restricted stock units that vest on April 1, 2019, inclusive of shares to be withheld for tax purposes. This number excludes 15,747,138 shares of Class A common stock issuable in exchange for LLC Units held by our executive officers and directors, based on an assumed price of $41.82 per share (the closing price of our Class A common stock on the NYSE on February 27, 2019). These shares of Class A common stock represent approximately 10% of the shares of Class A common stock that would be outstanding if all outstanding LLC Units were exchanged and all outstanding shares of Class B common stock were converted at that time.

ITEM 2 – RATIFICATION OF APPOINTMENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Audit Committee has appointed Grant Thornton LLP as our independent registered public accounting firm for the year ending December 31, 2019. Services provided to Carvana and its subsidiaries by Grant Thornton LLP for the year ended December 31, 2018 are described below and under "Audit Committee Report."

FEES AND SERVICES

The following table summarizes the aggregate fees for professional audit services and other services rendered by Grant Thornton LLP for the years ended December 31, 2018 and 2017:

SERVICES	2018	2017
Audit Fees	$1,524,986(1)	$1,061,451(3)
Audit-Related Fees	$ —	$ —
Tax Fees	$ 349,220(2)	$ 110,489
All Other Fees	$ —	$ —

(1) Includes the aggregate fees for the audit of our annual consolidated financial statements and internal controls, and the reviews of each of our quarterly consolidated financial statements. These fees also include procedures performed related to our follow-on offering completed in April 2018, registration of shares on Form S-3 in May and December 2018, and the issuance of our senior notes in September 2018.

(2) Includes the aggregate fees for tax return preparation and other tax compliance services.

(3) Includes $475,782 in fees related to our initial public offering in April 2017 that were reported in "All Other Fees" in our proxy statement prepared in connection with our 2018 annual meeting of stockholders.

In considering the nature of the services provided by the independent auditor, the Audit Committee determined that such services are compatible with the provision of independent audit services. The Audit Committee discussed these services with the independent auditor and Carvana management to determine that they are permitted under the rules and regulations concerning auditor independence promulgated by the SEC to implement the Sarbanes–Oxley Act of 2002, as well as the American Institute of Certified Public Accountants.

The Audit Committee has adopted a policy that requires advance approval of all audit services as well as non-audit services to the extent required by the Exchange Act and the Sarbanes–Oxley Act of 2002. Unless the specific service has been previously pre-approved with respect to that year, the Audit Committee must approve the permitted service before the independent auditor is engaged to perform it.

The Audit Committee approved all services provided by Grant Thornton LLP. Representatives of Grant Thornton LLP are expected to be present at the annual meeting. They will have the opportunity to make a statement if they desire to do so, and we expect that they will be available to respond to questions.

A UDIT COMMITTEE REPORT

The Audit Committee oversees our financial reporting process on behalf of the Board. The Audit Committee is composed of three independent directors (as defined by the New York Stock Exchange Listing Standards), met nine times in 2018, and operates under a written charter, which is posted on our website at investors.carvana.com/corporate-governance/governance-documents. As provided in the charter, the Audit Committee's oversight responsibilities include monitoring the integrity of our financial statements (including reviewing financial information, the systems of internal controls, the audit process, and the independence and performance of our internal audit function and independent registered public accounting firm) and our compliance with legal and regulatory requirements. However, management has the primary responsibility for the financial statements and the reporting process, including our systems of internal controls. In fulfilling its oversight responsibilities, the Audit Committee

- reviewed and discussed the audited financial statements for the year ended December 31, 2018, with our management;
- discussed with our independent auditors, Grant Thornton LLP, the matters required to be discussed by Public Company Accounting Oversight Board ("PCAOB") Auditing Standard No. 1301 (Communications with Audit Committees); and
- received the written disclosures and the letter from Grant Thornton LLP required by applicable requirements of the PCAOB regarding Grant Thornton LLP's communications with the audit committee concerning independence, and has discussed with Grant Thornton LLP the independence of Grant Thornton LLP.

Based on the Audit Committee's review and discussions noted above, the Audit Committee recommended to the Board of Directors that the audited financial statements be included in our Annual Report on Form 10-K for the year ended December 31, 2018.

Respectfully submitted by:

Ira Platt
Gregory Sullivan
Michael Maroone

ITEM 3 – SAY ON PAY

We are asking stockholders to approve, on an advisory basis, the compensation of our named executive officers as disclosed in the "Compensation Discussion and Analysis," the "Summary Compensation Table," and the related compensation tables and narrative. This item is being presented pursuant to Section 14A of the Securities Exchange Act of 1934. Although this advisory vote is not binding, the Compensation and Nominating Committee will consider the voting results when evaluating our executive compensation program.

Our executive compensation programs are designed to support our long-term success and reflect our pay-for-performance culture. Our company has grown dramatically over the years. Our growth has few historical precedents and makes us one of the fastest-growing technology, consumer, or retail companies at our scale, and in 2018 we continued to grow rapidly, with another year of triple-digit unit and revenue growth while simultaneously making significant progress in gross profit per unit and accelerating our operating leverage. We have a strong belief in promoting a pay-for-performance culture, and, accordingly, as described in the "Compensation Discussion and Analysis" of this proxy statement, the Compensation and Nominating Committee has set challenging performance targets based not on last year's achievements but continued rapid growth, and has structured our executive compensation program to tie total compensation to long-term stockholder value, as reflected primarily in our stock price. We believe that our executive compensation plans effectively support our strategic and financial goals, create a culture of teamwork, and are directly tied to the performance of the company and shareholder outcomes.

The Board recommends a vote "FOR" approval, on an advisory basis, of our executive compensation as described in this proxy statement.

ITEM 4 – SAY ON PAY FREQUENCY

Pursuant to Section 14A of the Exchange Act, we are asking stockholders to cast an advisory vote on the frequency of future advisory votes on executive compensation. Stockholders may specify whether they prefer such votes to occur every year, every two years, or every three years, or they may abstain. The Board recommends that this vote occur every year.

Although the stockholders' vote on this proposal is not binding, the Board will consider the voting results in determining the frequency of future advisory votes. Notwithstanding the Board's recommendation and the outcome of the stockholder vote, the Board may in the future decide to conduct advisory votes on a more or less frequent basis and may vary its practice based on factors such as discussions with stockholders and the adoption of material changes to compensation programs.

The Board recommends stockholders vote, on an advisory basis, to conduct future advisory votes on executive compensation every "ONE YEAR."

OTHER MATTERS

We are not aware of any matters other than those discussed in the foregoing materials contemplated for action at the annual meeting. The persons named in the proxy card will vote in accordance with the recommendation of the Board on any other matters incidental to the conduct of, or otherwise properly brought before, the annual meeting. The proxy card contains discretionary authority for them to do so.

INCORPORATION BY REFERENCE

The "Audit Committee Report" included in this proxy statement shall not be deemed soliciting material or filed with the SEC and shall not be deemed incorporated by reference into any prior or future filings made by us under the Securities Act or the Exchange Act, except to the extent that we specifically incorporate such information by reference. In addition, this document includes website addresses, which are intended to provide inactive, textual references only. The information on these websites is not part of this document.

AVAILABILITY OF SEC FILINGS, CODE OF CONDUCT, AND COMMITTEE CHARTERS

Copies of our reports on Forms 10-K, 10-Q, 8-K, all amendments to those reports filed with the SEC, our code of business conduct, corporate governance guidelines, the charters of the Audit Committee and Compensation and Nominating Committee, and any reports of beneficial ownership of our common stock filed by executive officers, directors and beneficial owners of more than 10% of our outstanding common stock are posted on and may be obtained through our website, investors.carvana.com, or may be requested in print, at no cost, by email at investors@carvana.com or by mail to Carvana Co., 1930 W. Rio Salado Pkwy, Tempe, AZ 85281, Attention: Investor Relations.

WHERE TO FIND ADDITIONAL INFORMATION

We are subject to the informational requirements of the Exchange Act and in accordance therewith, we file annual, quarterly, and current reports and other information with the SEC. This information can be inspected and copied at the Public Reference Room at the SEC's office at 100 F Street, N.E., Washington, D.C. 20549. You may obtain information on the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. Such information may also be accessed electronically by means of the SEC's home page on the internet at www.sec.gov. We are an electronic filer, and the SEC maintains an internet site at www.sec.gov that contains the reports and other information we file electronically. Our website address is investors.carvana.com. Please note that our website address is provided as an inactive textual reference only. We make available free of charge, through our website, our annual report on Form 10-K, as amended, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. The information provided on or accessible through our website is not part of this proxy statement.

COST OF PROXY SOLICITATION

Carvana is paying the expenses of this solicitation. Carvana will also make arrangements with brokerage houses and other custodians, nominees and fiduciaries to forward proxy materials to beneficial owners of stock held as of the record date by such persons, and Carvana will reimburse such persons for their reasonable out-of-pocket expenses in forwarding such proxy materials. In addition to solicitation by mail, directors, officers, and other employees of Carvana may solicit proxies in person or by telephone, facsimile, email, or other similar means.

ANNEX

100K MILESTONE GIFT

On September 10, 2018, we announced a commitment by our chief executive officer, Ernest Garcia III, to contribute 165 shares of Class A common stock to us from his personal shareholdings for every one of our then-existing employees upon their satisfying certain employment tenure requirements. In connection with these contributions, we have made corresponding grants of 165 restricted stock units under our 2017 Omnibus Incentive Plan to each employee who has satisfied the requirements and intend to make grants to the remaining then-existing employees as they satisfy the requirements (the “100k Milestone Gift” or “Gift”). Under U.S. GAAP, the 100k Milestone Gift is treated as compensation expense, a portion of which relates to the production of our used vehicle inventory and is therefore capitalized to inventory and subsequently recognized within costs of sales when the related inventory is sold.

NON-GAAP FINANCIAL MEASURES

To supplement the consolidated financial statements, which are prepared and presented in accordance with GAAP, we also present the following non-GAAP measures: gross profit ex-Gift, gross profit per unit ex-Gift, EBITDA ex-Gift, and EBITDA margin ex-Gift. We believe the presentation of both GAAP and non-GAAP financial measures provides investors with increased transparency into financial measures used by our management team, and it also improves investors’ understanding of our underlying operating performance and their ability to analyze our ongoing operating trends. All historic non-GAAP financial measures have been reconciled with the most directly comparable GAAP financial measures.

GROSS PROFIT EX-GIFT AND GROSS PROFIT PER UNIT EX-GIFT

Gross profit ex-Gift and gross profit per unit ex-Gift are non-GAAP supplemental measures of operating performance that do not represent and should not be considered an alternative to gross profit, as determined by GAAP. Gross profit ex-Gift is defined as gross profit before compensation expense related to the 100k Milestone Gift included in cost of sales. Gross profit per Unit ex-Gift is Gross Profit ex-Gift divided by units sold. We use Gross Profit ex-Gift to measure the operating performance of our business and Gross Profit per Unit ex-Gift to measure our operating performance relative to our units sold. We believe that Gross Profit ex-Gift and Gross Profit per Unit ex-Gift are useful measures to us and to our investors because they exclude the expense associated with the 100k Milestone Gift recognized in cost of sales. We expect the 100k Milestone Gift to be a one-time award program for which we will recognize varying amounts of expense beginning in the second half of 2018 and continuing through the first half of 2020, and therefore we believe the related expense does not reflect our core operations, is not included in our past operations, and may not be indicative of our future operations. Additionally, the shares issued to settle the 100k Milestone Gift are offset by share contributions from Mr. Garcia to Carvana, therefore we expect the impact on shares outstanding to be nearly zero. We believe that excluding it enables us to more effectively evaluate our performance period-over-period and relative to our competitors.

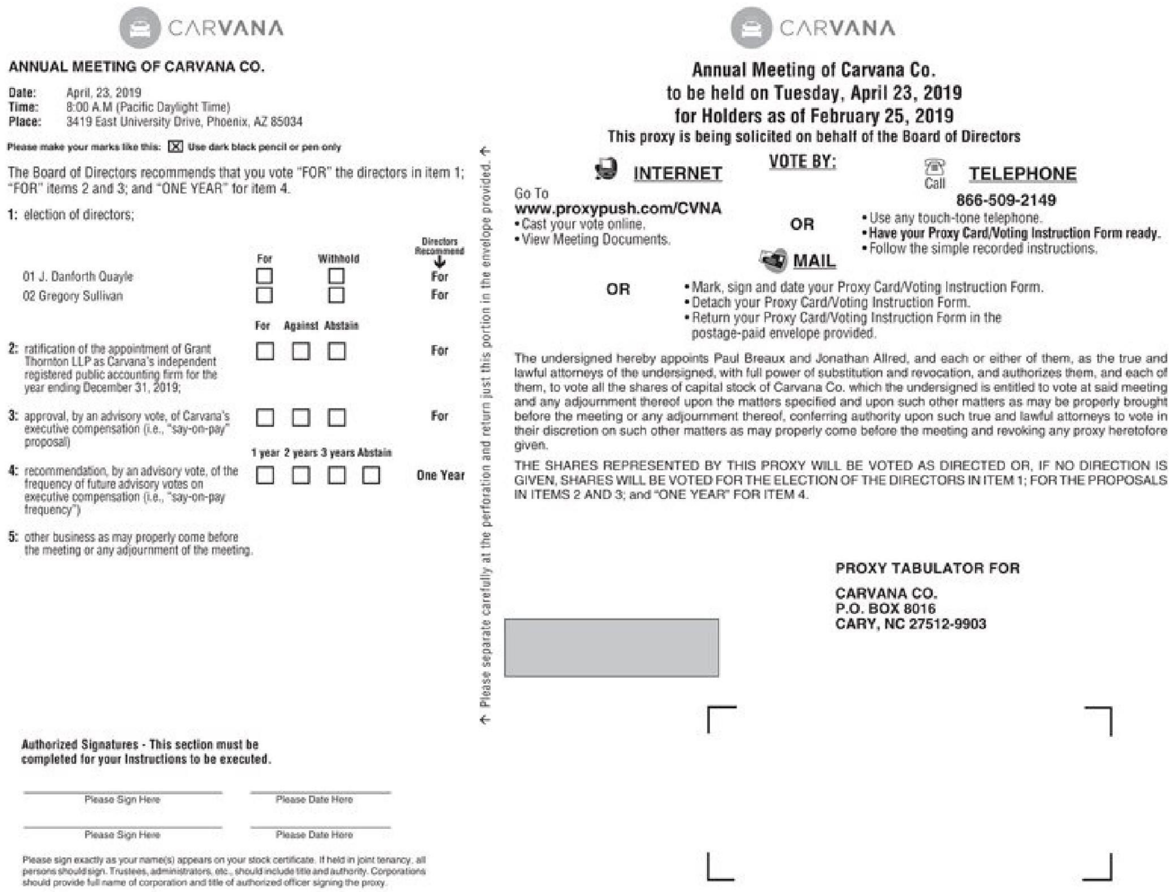
A reconciliation of the gross profit ex-Gift amounts to each corresponding gross profit amount, which are the most directly comparable GAAP measures and include expenses attributable to the 100k Milestone Gift, and calculations of each gross profit per unit ex-Gift amount are as follows (dollars in thousands, except per unit amounts):

	YEARS ENDED DECEMBER 31,		
	2018	2017	2016
Used vehicle gross profit	$ 94,319	$32,806	$ 5,944
100k Milestone Gift in used vehicle cost of sales	3,870	—	—
Used vehicle gross profit ex-Gift	$ 98,189	$32,806	$ 5,944
Used vehicle unit sales	94,108	44,252	18,761
Used vehicle gross profit per unit ex-Gift	$ 1,043	$ 741	$ 317
Wholesale vehicle gross profit	$ 5,552	$ 1,845	$ 257
100k Milestone Gift in wholesale vehicle cost of sales	133	—	—
Wholesale vehicle gross profit ex-Gift	$ 5,685	$ 1,845	$ 257
Wholesale vehicle unit sales	15,125	6,509	2,651
Wholesale vehicle gross profit per unit ex-Gift	$ 376	$ 283	$ 97
Total gross profit	$196,709	$68,091	$19,197
100k Milestone Gift in total cost of sales	4,003	—	—
Total gross profit ex-Gift	$200,712	$68,091	$19,197
Used vehicle unit sales	94,108	44,252	18,761
Total gross profit per unit ex-Gift	$ 2,133	$ 1,539	$ 1,023

EBITDA EX-GIFT AND EBITDA MARGIN EX-GIFT

EBITDA ex-Gift and EBITDA margin ex-Gift are non-GAAP supplemental measures of operating performance that do not represent and should not be considered an alternative to net loss or cash flow from operations, as determined by GAAP. EBITDA ex-Gift is defined as net loss before interest expense, income tax expense, depreciation and amortization expense, and the compensation expense related to the 100k Milestone Gift. EBITDA margin ex-Gift is EBITDA ex-Gift as a percentage of total revenues. We use EBITDA ex-Gift to measure the operating performance of our business and EBITDA Margin ex-Gift to measure our operating performance relative to our total revenues. We believe that EBITDA ex-Gift and EBITDA margin ex-Gift are useful measures to us and to our investors because they exclude certain financial and capital structure items and the expense associated with the 100k Milestone Gift that we do not believe directly reflect our core operations and may not be indicative of our recurring operations, in part because they may vary widely across time and within our industry independent of the performance of our core operations. In particular, we expect the 100k Milestone Gift to be a one-time award program for which we will recognize varying amounts of expense beginning in the second half of 2018 and continuing through the first half of 2020, and therefore we believe the related expense does not reflect our core operations, is not included in our past operations, and may not be indicative of our future operations. Additionally, the shares issued to settle the 100k Milestone Gift are offset by share contributions from Mr. Garcia to Carvana; therefore, we expect the impact on shares outstanding to be nearly zero. We believe that excluding these items enables us to more effectively evaluate our performance period-over-period and relative to our competitors. EBITDA ex-Gift and EBITDA margin ex-Gift may not be comparable to similarly titled measures provided by other companies due to potential differences in methods of calculations. A reconciliation of EBITDA ex-Gift to net loss which includes 100k Milestone Gift expense and is the most directly comparable GAAP measure, and calculation of EBITDA margin ex-Gift is as follows (dollars in thousands):

	YEARS ENDED DECEMBER 31,				
	2018	2017	2016	2015	2014
Net loss	$(254,745)	$(164,316)	$(93,112)	$(36,780)	$(15,238)
Depreciation and amortization expense	23,539	11,568	4,658	2,800	1,706
Interest expense	25,018	7,659	3,587	1,412	108
100k Milestone Gift	11,821	—	—	—	—
EBITDA ex-Gift	$(194,367)	$(145,089)	$(84,867)	$(32,568)	$(13,424)
Total revenues	$1,955,467	$858,870	$365,148	$130,392	$41,679
Net Loss Margin	(13.0)%	(19.1)%	(25.5)%	(28.2)%	(36.6)%
EBITDA Margin ex-Gift	(9.9)%	(16.9)%	(23.2)%	(25.0)%	(32.2)%



CARVANA

ANNUAL MEETING OF CARVANA CO.

Date: April, 23, 2019
Time: 8:00 A.M (Pacific Daylight Time)
Place: 3419 East University Drive, Phoenix, AZ 85034

Please make your marks like this: ☒ **Use dark black pencil or pen only**

The Board of Directors recommends that you vote "FOR" the directors in item 1; "FOR" items 2 and 3; and "ONE YEAR" for item 4.

1: election of directors;

	For	Withhold	Directors Recommend ↓
01 J. Danforth Quayle	☐	☐	For
02 Gregory Sullivan	☐	☐	For

	For	Against	Abstain	
2: ratification of the appointment of Grant Thornton LLP as Carvana's independent registered public accounting firm for the year ending December 31, 2019;	☐	☐	☐	For
3: approval, by an advisory vote, of Carvana's executive compensation (i.e., "say-on-pay" proposal)	☐	☐	☐	For

	1 year	2 years	3 years	Abstain	
4: recommendation, by an advisory vote, of the frequency of future advisory votes on executive compensation (i.e., "say-on-pay frequency")	☐	☐	☐	☐	One Year

5: other business as may properly come before the meeting or any adjournment of the meeting.

Authorized Signatures - This section must be completed for your Instructions to be executed.

Please Sign Here ________________ Please Date Here ________________

Please Sign Here ________________ Please Date Here ________________

Please sign exactly as your name(s) appears on your stock certificate. If held in joint tenancy, all persons should sign. Trustees, administrators, etc., should include title and authority. Corporations should provide full name of corporation and title of authorized officer signing the proxy.

← Please separate carefully at the perforation and return just this portion in the envelope provided. ←

CARVANA

Annual Meeting of Carvana Co.
to be held on Tuesday, April 23, 2019
for Holders as of February 25, 2019

This proxy is being solicited on behalf of the Board of Directors

VOTE BY:

INTERNET

Go To
www.proxypush.com/CVNA
- Cast your vote online.
- View Meeting Documents.

OR

TELEPHONE

Call
866-509-2149
- Use any touch-tone telephone.
- **Have your Proxy Card/Voting Instruction Form ready.**
- Follow the simple recorded instructions.

OR

MAIL

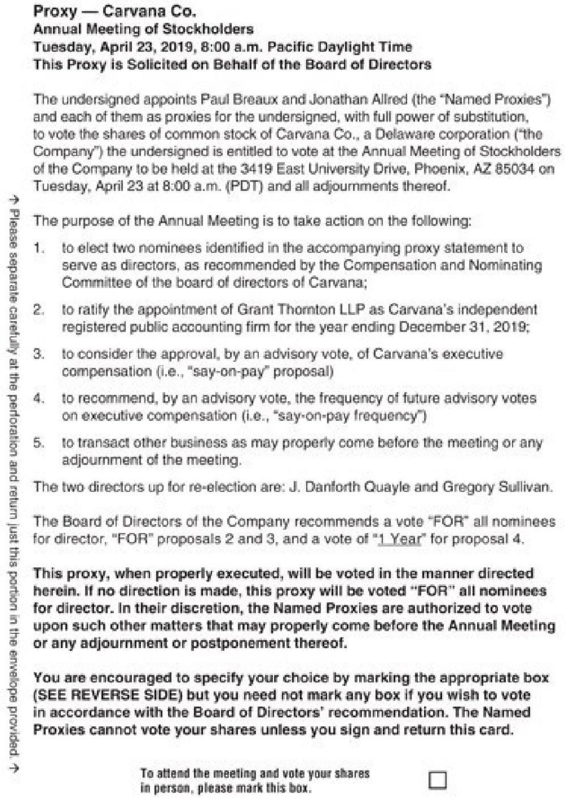
- Mark, sign and date your Proxy Card/Voting Instruction Form.
- Detach your Proxy Card/Voting Instruction Form.
- Return your Proxy Card/Voting Instruction Form in the postage-paid envelope provided.

The undersigned hereby appoints Paul Breaux and Jonathan Allred, and each or either of them, as the true and lawful attorneys of the undersigned, with full power of substitution and revocation, and authorizes them, and each of them, to vote all the shares of capital stock of Carvana Co. which the undersigned is entitled to vote at said meeting and any adjournment thereof upon the matters specified and upon such other matters as may be properly brought before the meeting or any adjournment thereof, conferring authority upon such true and lawful attorneys to vote in their discretion on such other matters as may properly come before the meeting and revoking any proxy heretofore given.

THE SHARES REPRESENTED BY THIS PROXY WILL BE VOTED AS DIRECTED OR, IF NO DIRECTION IS GIVEN, SHARES WILL BE VOTED FOR THE ELECTION OF THE DIRECTORS IN ITEM 1; FOR THE PROPOSALS IN ITEMS 2 AND 3; and "ONE YEAR" FOR ITEM 4.

PROXY TABULATOR FOR

CARVANA CO.
P.O. BOX 8016
CARY, NC 27512-9903



Proxy — Carvana Co.
Annual Meeting of Stockholders
Tuesday, April 23, 2019, 8:00 a.m. Pacific Daylight Time
This Proxy is Solicited on Behalf of the Board of Directors

The undersigned appoints Paul Breaux and Jonathan Allred (the "Named Proxies") and each of them as proxies for the undersigned, with full power of substitution, to vote the shares of common stock of Carvana Co., a Delaware corporation ("the Company") the undersigned is entitled to vote at the Annual Meeting of Stockholders of the Company to be held at the 3419 East University Drive, Phoenix, AZ 85034 on Tuesday, April 23 at 8:00 a.m. (PDT) and all adjournments thereof.

The purpose of the Annual Meeting is to take action on the following:

1. to elect two nominees identified in the accompanying proxy statement to serve as directors, as recommended by the Compensation and Nominating Committee of the board of directors of Carvana;
2. to ratify the appointment of Grant Thornton LLP as Carvana's independent registered public accounting firm for the year ending December 31, 2019;
3. to consider the approval, by an advisory vote, of Carvana's executive compensation (i.e., "say-on-pay" proposal)
4. to recommend, by an advisory vote, the frequency of future advisory votes on executive compensation (i.e., "say-on-pay frequency")
5. to transact other business as may properly come before the meeting or any adjournment of the meeting.

The two directors up for re-election are: J. Danforth Quayle and Gregory Sullivan.

The Board of Directors of the Company recommends a vote "FOR" all nominees for director, "FOR" proposals 2 and 3, and a vote of "1 Year" for proposal 4.

This proxy, when properly executed, will be voted in the manner directed herein. If no direction is made, this proxy will be voted "FOR" all nominees for director. In their discretion, the Named Proxies are authorized to vote upon such other matters that may properly come before the Annual Meeting or any adjournment or postponement thereof.

You are encouraged to specify your choice by marking the appropriate box (SEE REVERSE SIDE) but you need not mark any box if you wish to vote in accordance with the Board of Directors' recommendation. The Named Proxies cannot vote your shares unless you sign and return this card.

To attend the meeting and vote your shares in person, please mark this box. ☐

→ Please separate carefully at the perforation and return just this portion in the envelope provided. →

REMEMBERING CAVALIER MAGAZINE

LAUNCHING A MAGAZINE

My friend Michael Simmons, who has been the editor of *National Lampoon*, recalls that *Cavalier* hired fine scribes. A few examples: Thomas Pynchon, Philip Roth, William Saroyan, Isaac Asimov, Theodore Sturgeon. Characters show up from Andy Warhol to Timothy Leary. And the photos of models weren’t even soft porn, merely tits and ass.

Cavalier was launched by Fawcett Publications in 1952. Men’s magazine *Cavalier* (motto: “For the American Male”) was published the year before *Playboy,* to whom it has often been compared. Back in the day, *Cavalier* tried to be seen as slightly hipper, more youthful, and considered a bit more clever than its big name rival. Almost an anti-establishment in *Playboy.* A slogan stated: “Your dad bought *Playboy*, you bought *Cavalier*."

I BECAME A COLUMNIST

I was invited to write a column, named “The Naked Emperor,” for *Cavalier*, that was beginning to publish underground writers and artists. They paid me $1,000 a month. My first column, in 1964, was a report on an auction of two-inch squares from the hotel bedsheets slept on by the Beatles during their first trip to America.

There were 300 screaming young girls, off on a fetishist’s holiday. Obviously, there wouldn’t be enough items to go around, but it was announced that the Beatles’ unwashed towels and bed linens were to be cut into two-inch squares and sold for $1 each. The price included a notarized statement of authenticity.

My second column was about Lenny Bruce—titled “Lenny the Lawyer,” since he defended himself in trials He was arrested for obscene performances only because there were no blasphemy laws, and he ridiculed religious leaders. I went to the bank and deposited my check, withdrawing half of it in cash, a $500 bill. Lenny was alone in his funky hotel room on Christmas Day when I presented it to him. And, with a large safety pin, Lenny attached the $500 bill to the outside breast pocket of his dungaree jacket.

AFTER JFK ASSASSINATION

In another column of mine, “Jack Ruby and His Dirty Little Secret,” it began, “Lenny Bruce once told me how all the night club comics used to gossip about Jack Ruby’s “tattoo of a lady' s *schmutzik* (translate: pussy) in his armpit." If it weren' t a fact, I was quite willing to settle for an apocryphal allusion which nevertheless crystallized the entire personality of that alleged murderer who wanted so very much to be liked.

I say *alleged* because upon Ruby' s own death. Dallas District Attorney Henry Wade said he would dismiss the murder charge against him, a promise which has since been kept, although no such posthumous grace was ever officially bestowed on Lee Harvey Oswald, considered a lone assassin who shot President Kennedy. See, they grant you retroactive innocence only in the face of innumerable witnesses who were present at the actual event through the legal miracle of inadvertent televised coverage.

Now Jack Ruby' s dirty little secret has been forever sealed away in his armpit by the hymen of history. Oh yeah, and at Lenny' s funeral, that safety pin was still attached on his denim jacket.

JULES SIEGEL

Two years before Lenny' s death, with his permission I published his obituary in my own magazine, *The Realist.* Before the issue went to press, he called his mother and a few others to let them know it would only be a hoax. The point was that he couldn't get work and his work was his life so he might as well be dead. And if people regretted that they hadn't helped him, well, now they could have a second chance because he was still alive. The obituary evoked inquiries from newspapers, wire services, foreign publications, radio and TV.

"What's the meaning of it?" one editor asked me. "There's a lot of excitement at the city desk."

"That *is* the meaning of it."

A few years later, without my permission, Jules Siegel, the editor of a short-lived magazine, *Cheetah*, published a fake obituary of me. I thought it was funny. An Associated Press reporter called, and I explained that it was a hoax.

"Are you sure?" he asked.

"Of course. I would tell you if I was dead."

Siegel started writing for *Cavalier.* His first assignment was a profile of Sterling Hayden, an actor best known in *Dr, Stranglove or How I Learned to Stop Worrying and Love the Bomb.*

Journalist Adam Ellsworth described Siegel' s "Goodbye Surfing, Hello God" with his most famous example of rock journalism, though his most revolutionary was his article, "The Big Beat." It appeared in the *Playboy*-esque *Cavalier* magazine in 1965 and was one of the earliest writings he' d ever seen on the development of rock and roll, from slaves singing in chains on their way to America to Bob Dylan "going electric" at the Newport Folk Festival.

Then Jules' friend, Arthur Kretchmer, became *Cavalier' s* managing editor. "When the editorial director later resigned," Kretchmer said, "there was a 24-hour hiatus before the new editorial director arrived." Siegel and Kretchmer had been discussing the possibility of publishing an issue on rock and roll, so to make it happen, Kretchmer went into the office at night and retyped the magazine' s schedule to include their ideas.

When the new editorial director started, Kretchmer handed him the schedules and said, "Here' s what we' re working on." The new editorial director suspected nothing and the rock and roll issue went ahead. Once the laughter died down, Jules talked for a good 25 minutes about some of the ups and downs of his writing career and how hard it is to make a living as any kind of a writer, let alone a "rock journalist." and the people who created it, seriously.

Now everybody writes about rock and roll that way. Jules was one of the people who did it first. He died of a heart attack on November 17, 2012 at the age of 77. He was a brilliant author, but neither *Rolling Stone* nor the *New York Times* honored him with an obituary. Not even a fake one.

COMIX

Art Spiegelman tells me his work at *Cavalier* 50 years ago:

I was first invited into the mag to do two full-color comix pages in 1969 (when being printed in color was a Very Big Deal for me as was Getting Paid more than 25 bucks for a drawing), somehow in proximity to a big article on underground comix. It was around the time Vaughn Bode was made a regular contributor to the magazine, They were running some Crumb "Fritz the Cat" pages. All thanks to their hip, laid back and kind editor, Alan LeMond.

I also did some gag cartoons, short strips and occasional illustrations for *Cavalier* (one especially bad drawing for a story by Bruce Jay Friedman, I recall). My work as an apprentice underground cartoonist taking too many drugs was really, really awful. By the time I'd gotten incrementally better as a cartoonist in the first half of the 1970s I was regularly doing illustrations for soft-core fiction stories in *Cavalier's* low-rent sister mags, *Dude, Gent* and *Nugget* (even wrote a story or two there and got several of my San Francisco comix cronies -- Spain Rodriguez, Bill Griffith and Justin Greene) illustration gigs for those mags as well.

[Note in Wikipedia: *Maus* is a graphic novel by American cartoonist Art Spiegelman, serialized from 1980 to 1991. It depicts Spiegelman interviewing his father about his experiences as a Polish Jew and Holocaust survivor. The work employs postmodernist techniques and represents Jews as mice, Germans as cats, and Poles as pigs. In 1992, *Maus* won a Pulitzer Prize.]

COMiING AND GOING

I wrote some movie reviews for *Cavalier.* I recall that *Midnight Cowboy* was 50 years ago. I always went to two screenings. The first one I would go stoned with magic mushrooms. The second one I took notes. However, I got fired by *Cavalier.*

They declined to publish a particular column–-my review of *MASH* as though it were a Busby Berkeley musical called *Gook Killers of 1970-–* ostensibly on the grounds of bad taste, but I learned that three wholesalers had told the publisher they were pressured by the FBI and would refuse to distribute *Cavalier* if my name appeared in it.

On top of that, my name was on a list of sixty-five "radical" campus speakers, released by the House Internal Security Committee. The blacklist was published in the *New York Times*, and picked up by newspapers across the country. It might have been a coincidence, but my campus-speaking engagement-bookings stopped abruptly. It felt just like a film.

OH, WELL

It was over for me, but it had been fun—like the issue with only the one large red headline on the *Cavalier* cover: "BEAT 'EM SENSELESS FIRST" —THE FREE SPEECH CONTROVERSY, BY PAUL KRASSNER...

At the University of California in Berkeley on September 1964, Dean Katherine Towle banned posters, easels and tables at the Bancroft-Telegraph Street entrance to the Berkeley campus "because of interference with flow of traffic." She also reminded student groups of "rules prohibiting the collection of funds and the University facilities for the planning and implementing of off-campus political and social action."

As a result, students held a sit-in lasted till 3 a.m. Next day, ten tables were manned again, and a campus policeman approached one of the tables (manned by the Congress of Racial Equality) where a dozen persons were seated. One was singled out and placed under arrest. But before you could say nonviolent demonstration, the police car was surrounded, its captors reaching as many as 3,000 students. During the late evening, bored fraternity men gathered and tossed lighted cigarettes and eggs on those sitting in the plaza. The demonstrators responded with silence.

Next day, 450 police assembled on campus to remove the cop car and its arrested inhabitant, but an agreement to negotiate was reached and the demonstrators dispersed. One of the folk songs to come out of the Free Speech Movement was *If I Negotiate With You* to the tune of the Beatles' *If I Fell in Love With You.*

Over the next couple of months there was a series of sit-ins and attempted negotiations, and then, on December 2, the infamous Sproul Hall sit-in. It took twelve hours for 800 students to be arrested by some 600 instructors of a new course called Introductory Police Brutality. These were from the lab notes student took:

"We should do like they do in them foreign countries—beat 'em senseless first, then throw them in the bus."

There was a freshman co-ed at Berkeley who—long after she had forgotten what some professor spouted during an official lecture about Dostoevsky's *Crime and Punishment*—would remember, with perhaps a twinge of frightened pride, learning from a fellow demonstrator that if she planned to go limp when the police arrested her, it would be an act of practical feminine foresight to remove the earrings from her pierced lobes in advance.

So, now in 2019, fighting over free speech has been happening heavily at Berkeley campus again. Meanwhile, Trump grabbed the pussy of the Statue of Liberty. *Cavalier,* anyone?

From: Bill Siegel [redacted]
Sent: 2/8/2013 7:40:43 PM
To: Charlotte Abrams [redacted]
Subject: Fro- The Control Factor - Frontpage Magazine interview
Attachments: image001.gif; image002.jpg; image003.png; image004.png; image005.jpg; image006.jpg; image007.png

Bill Siegel hopes this might be of interest to you: http://frontpagemag.com/2013/jamie-glazov/the-control-factor-our-struggle-to-see-the-true-threat/

The Control Factor: Our Struggle to See the True Threat

February 8, 2013 By Jamie Glazov Comments (6)

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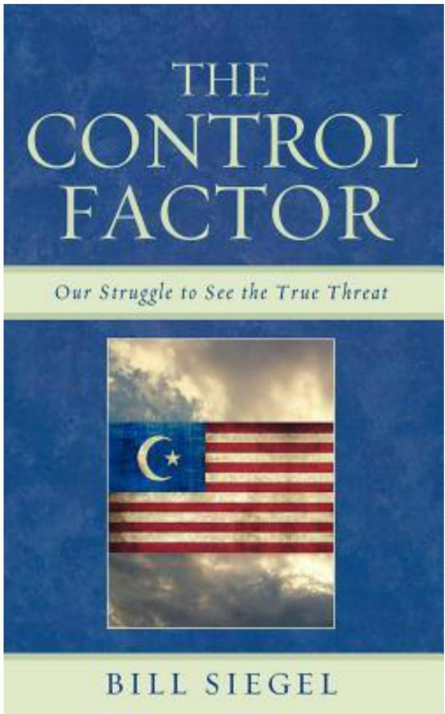
Print This Post



FrontPage Interview's guest today is Bill Siegel, a lawyer and business executive. He has been a producer of several documentary films and assists numerous non-profit organizations. He is the author of The Control Factor: Our Struggle to See the True Threat.

FP: Bill Siegel, welcome to FrontPage Interview.

Congratulations on this brilliant book. It is without question one of the most vital works of our time.

Let's begin with what inspired you to write it.

Siegel: Thanks for having me Jamie. As a young boy born in the mid 1950s, I was fascinated with footage of Hitler and the Third Reich and could never understand how the Jews of the time could not see the evil that seemed so obvious. Not yet appreciative of the benefit of hindsight, I could not comprehend the blindness. Following 9/11, like so many others, I began to study Islam, its history, its current movements, terrorism and so on. As I would learn one stunning aspect after another, I would discuss them with friends and associates. Rather than confront the facts I would present, they would find one clever way after another to avoid the frightening truth of what America and the West truly face. Their fear appeared obvious to me. I began to catalog many of my friends' different maneuvers to dispel the anxiety that they found so difficult to endure. The more I focused on their mental processes (as well as my own) the more I began to see a structure to the mental endeavor and to understand what I had, as a child, found so difficult to explain.

FP: Tell us about the Control Factor, what you describe as "that effort our minds engage in in order to keep us blind" and that "process of avoiding seeing the threats we face." It's also about, as you state, trying to believe that the threat is under our control, when in fact it is not. Kindly enlighten us as to these profound insights you make in terms of the Control Factor.

Siegel: First, let's distinguish the "real world" where real battles are taking place from the mental battlefield which occurs in each of our minds. We tend to believe our perceptions are simply clear realizations of what is "out there" and overlook how much our internal worlds can literally determine what we see. When our internal minds become anxious and sense a loss of "control," they tend to concoct ways to distort our perceptions so as to restore that sense of inner control. I describe the Control Factor as an "active and continuous process" designed to maintain that sense, if not illusion, of control. We naturally think that our thinking and feeling processes are passive; that they just happen. Yet when faced with truly frightening prospects, the mind is geared to actively distort.

Similarly, the sense of control must be continuously maintained so the Control Factor operates constantly. In turn, the sum of this active and continuous undertaking makes these perceptions all the more familiar and thus seemingly all the more "real." In one sense, the Control Factor is the mechanism of what Andy McCarthy entitled one of his numerous excellent books- willful blindness. The Control Factor is cleverer than we are aware; that is almost tautological as, if our minds are to create ways to keep us in denial, they must out maneuver our conscious thinking.

Since World War II, America has had limited experience with threats coming to the homeland. Most of America's history has been about "over there," where we have always known that if things got too out of hand (e.g. Vietnam) we could always return home. The current generations, for a wide array of reasons, have had virtually no experience with a threat to this land. (The documentary, Generation Zero, is interesting on this point).

Consequently, the process of waking up to such a threat parallels the arc of a typical horror film. In such a film, there is typically a cast of characters surrounding one or two main characters. We in the audience know there is a threat coming – be it a monster, a virus, a psycho killer, an alien, the blob that ate Cincinnati etc. This threat is typically defined by its intent- the singular goal of destroying the characters. Much of the initial exposition shows how the characters first are oblivious to the destruction the threat brings about, then explain it in familiar terms only to finally open their eyes to see that something uniquely terrifying is happening. The next stage usually involves a series of failed attempts to deal with the threat- from trying to negotiate with it, to appease it, to coax it, to threaten it with ineffective weapons and so forth. Most of these failings are due to not adequately appreciating the threat for what it truly is and projecting onto it a host of other attributes instead. The final stage generally involves a back-up-against-the-wall decision by whichever characters remain alive. I named this the "turnaround moment" when the character becomes willing to be as ruthless as the threat. That change in mental state is necessary to ensure survival. Ultimately, the storyline is a race for whichever characters remain to wake up fully and use whatever advantages they may still have to beat the threat.

This is the same arc our minds go through in battling our own Control Factors, our own compulsions to deny that which is staring us in the face. Ultimately, the question is whether we will be able to wake up while we still have advantages and give ourselves permission to fully fight the battle we are in.

I said earlier that there is a structure to the Control Factor. To oversimplify, I view it much as a pyramid where on the bottom are the many minute by minute thoughts that are manipulated. I call this level of maneuvers the many "D's" as they include the psychological defenses such as distortion, denial, demonization, deflection, deletion, detachment, delusion, displacement, discolorization and so forth. Layered upon these are moves such as projection, where we can assign to our Islamic Enemy traits we wish to see in them or introject traits from them into ourselves that we wish not to acknowledge. These maneuvers involve a mixing of identities where we actually lose clarity about who we are and who the enemy is. Projection and introjection are active almost across the board. It is always helpful, for instance, to ask how what the enemy accuses us of is more appropriately descriptive of it. When we add Western Guilt and Shame, our need to be liked, and other psychological dimensions, basic thoughts solidify into larger fantasies.

As these narratives ("Our courts will never allow that," "As a superpower we will always be able to win any fight we put our minds to," "Assimilation will ensure Muslims are westernized" …) gain consent from others they tend to guide us deeply and become infused on our policies. Ultimately, what emerges is a relationship we take with our Islamic Enemy that parallels that between an addict and an enabler. Emblematic of this relationship is the "transfer of responsibility" in which we assume responsibility for the enemy's behavior who is addicted to transferring it away from itself. The Control Factor actively maintains this relationship and makes changing that relationship as difficult a chore as any addict finds in breaking his addiction. And just as an addict needs to devote serious effort and consciousness to his addiction, so must we devote great energy to understanding how the Control Factor ultimately sabotages us.

FP: Describe the threat we face in our Islamic enemy. And you talk about the three levels of jihad against us. What are they?

Siegel: Simply stated, our Islamic Enemy seeks the totalitarian domination of Islam throughout the world – Islamic supremacy. It seeks to have the West submit to Islam. Obviously, this does not mean that everybody becomes a Muslim. Islam, in all its varied expressions, permits dhimmis- those Christians, Jews, and some others who are permitted to remain as protected non-Muslims as long as they submit to an inferior status. What is critical is that Shariah (Islamic Law) ultimately rules the world.

Jihad, loosely, is the effort/struggle to see this vision through. The most obvious method of Jihad is through violence; it is the one most familiar to most Westerners and almost all of the Koranic references to Jihad are based in violence. The Violent Jihad includes al-Qaeda and its offshoots as well as other groups that formed around the globe independent of al-Qaeda. It also obviously includes the violence from Islamic nations such as the Islamic Republic of Iran whose constitution specifies such vision. It also includes, however, various militant groups and training camps here in the US as well as ad hoc efforts of individuals.

Since 9/11, there have been something in excess of 15,000 Violent Jihadic attacks across the globe. However, as terrible as this is, we have a tendency in the West to think that the only dimension of threat we face comes from violence. While the Bush administration helped initiate this thinking, the Obama administration has actively abused it by limiting any discussion of the threat we face to al-Qaeda and some other terrorist groups abroad. As frightening as these groups are, we can get some ease from thinking they are a band of "extremists limited in number, weaponry, sophistication, and means. Stunningly, Hillary Clinton recently estimated that there are only about 50,000 "homicidal" violent extremists around the world who simply have been able to project power much greater than their number should allow. Here the Control Factor makes the threat appear more easily manageable.

Jihad, however, is pursued in other often even more effective ways which I have grouped into three "levels." A second more insidious level of threat is what the Muslim Brotherhood itself called the "Civilization Jihad." It is the effort to infiltrate all aspects of our society, peacefully according to our laws, in order to later be in position to sabotage and destroy it from the inside. The Civilization Jihadists have learned the culture and rules of the territories they seek to command and use those rules to maneuver—specifically using our freedoms to destroy our freedoms. They use "lawfare" to seek changes in our laws so as to push Shariah into our society. Your readers should read Daniel Pipes and Brooke Goldstein's Lawfare Project material and others to fully appreciate how cancerous this activity has become. This includes intimidating in a variety of ways anyone who speaks out against them or Islam and seeking to squelch our treasured broad right to free speech so as to ultimately prevent any criticisms of Islam. Once criticism of Islam is prohibited, little can stop it from cascading throughout the culture.

The Civilization Jihad includes situating such Jihadists in critical positions in the society, in the government, in the legal system, the military, and elsewhere. It includes the control over university programs that distribute propaganda about Islam and Islamic history which then filters down throughout textbooks for even younger students. It includes control over most of the nation’s mosques and local Imams guiding the messages engaged Muslims are receiving. Most troublesome are the Muslim groups (CAIR, ISNA, MSA and others associated and/or joint venture partners with the Muslim Brotherhood) supposedly interested in “outreach” which know how to appear Westernized and interested in the goals of Western Civilization. They have fooled a large part of our authorities and media due in part to their patience and willingness to chip away, one airport prayer room, one frivolous intimidating lawsuit, one Congressman or CIA officer, one mosque, one ruling at a time.

Particularly in the US, given our deep attachment to freedom as well as cultural and psychological tendencies toward diversity, Western guilt and expectations of truthfulness, this effort is devious and difficult to uproot. The Civilization Jihadists present one face to the American public which is completely at odds with their true agenda and how they deal in private. Jamie, you and David and others such as Steve Emerson, Frank Gaffney, Andy McCarthy and others have done so much to uncover this level of Jihad that your readers should be urged to review as much of their work (including Steve’s recent excellent documentary, The Grand Deception, and Frank’s important web video course, The Muslim Brotherhood in America) as possible.

Finally, there is a third level – the International Institutional Jihad. Here the most powerful international institutions such as the UN and the Organization of Islamic Cooperation and others seek to push into America from without those changes which are difficult to complete from within. The OIC is the largest Islamic institution in the world. It essentially controls the vote in the UN’s General Assembly and thus explains in part the absurd and abject pro-Islamic, anti-Israel thrust of that organization. This level seeks to use the power of Islamic nations to work from outside the West to force changes within the West. While there are various conflicts between many of the nations, being Islamic majority states, there is a great deal they agree upon which becomes the focus of these efforts. Just as the Obama administration is beginning to cooperate with international efforts to control gun ownership, so has Hillary Clinton’s Istanbul Process become a dangerous step in the effort to restrict speech critical of Islam by norm (or possibly even treaty) when it may not be fully executable by domestic action alone.

I should point out that Stephen Coughlin, the former Pentagon officer who has an important must-see presentation of Islamic Law, uses different names for these same three levels – Jihad, Dawa, and Ummah. Had I seen his work before I wrote my book I would have conformed to his categorizations.

We must learn how powerful language has become on all three levels. Words such as “peace,□ $B!I “freedom,” ”terrorism,” and phrases such as “human rights” have different meanings for us and for our Islamic Enemy. To oversimplify, “peace” is not something for now but that which comes when all the earth is submitting to Islam. In the context of battles, “peace” is at best a temporary ceasefire. “Freedom” is best understood as having the freedom to fully submit to Islam, not to choose whatever beliefs one desires while respecting the same right in others. We’ve all seen how ”human rights” and “terror” really only apply among Muslims, not to non-Muslims. Our enemy fully understands these differences and uses them at all levels to paralyze us.

Look simply at how the phrase “Israeli-Palestinian conflict” has equalized the two parties, making it all the easier to ascribe features of one to the other and view the problem as a simple-to fix division of assets into statehoods but for personality problems among the leaders. The simple truth is that this is and has always been a one-sided Arab war against Israel as Ruth Wisse and others have described and, as Bibi Netanyahu made clear, the ONLY state truly at issue here has been the State of Israel that the Arabs have refused for over half a century. Nonetheless, the Control Factor hypnotically abuses the mind’s susceptibility to the intricacies of language.

Even the label “Peace Process” has been damaging language. While most focus upon the first word, turning this into a “process” has helped ensure that peace is never obtained. It is more appropriately called the “Extortion Process” because all that results is that violence is used over decades to extract concessions from Israel.

These three levels must be understood for their differences while united by a single goal. While these levels often operate together and assist each other, we must avoid "level confusion" which the Control Factor employs to curtail our fears. If the Obama narrative is swallowed- that the only threat is the Violent Jihad- we will miss the other contamination fomenting within our borders. We must appreciate how these levels work together and even unite with other forces such as the global Leftist movement that you, Jamie, have described so forcefully in United in Hate.

FP: You write about how we like to talk of "Good Muslims" and how we are always on the eternal search for "moderate" Muslims (Khatami, Mousavi, Abbas, etc), while we stress how the "extremists" are the real problem and how "few" they really are. All of this is connected to the Control Factor. Enlighten us.

Siegel: The Control Factor seeks to have us feel in control of the situation. The easiest way to do this is to simply minimize the number of potential enemies. We have been lectured for years about how Islam is a "religion of peace" and that the violence we see (remember that we have already improperly limited the problem to violence) is the product of a small number of "crazies" (remember Hillary Clinton's 50,000) who have distorted Islam. I call this the "Peaceful Muslim Disclaimer" as virtually everyone in the press and government has been bullied into making some statement of the kind to silence those who will pressure them that they are "Islamophobic" and Islam is being attacked. (These are the Islam hustlers who operate on the same principles that black race hustlers so effectively used to extort concessions over the last six decades or so).

Nobody has done any real work to support this proposition, nor is it clear exactly how it would be tested. My view is that the grammar "Islam is x" is itself problematic because Islam has expressed itself throughout history in a variety of fashions. It is more useful to talk in terms of how seriously engaged with Islam, the Koran and other texts, a Muslim is. What is significant is how Muslims today are using Islam and most of those who are in power either throughout a large territory or within a small community tend toward, if not fully advocate, the very supremacist ideas that we try to tell ourselves are reserved for the few "extremists." Presumably most Germans did not wish to see all Nazi atrocities carried out but in the end they fell in line because they had to. Those our politicians and press call the "extremists" are in one sense more accurately the "good" Muslims who are following their Islamic beliefs dutifully.

FP: Tell us how Western shame and guilt play into all of this.

Siegel: One of the dirty little secrets the Control Factor preys upon is that if we believe we control something we can comfort ourselves that we can change it. Remember the horror film- the threat has one purpose and that is to destroy you. You can not change it, talk it out of it, teach it alternatives or otherwise. That is what makes it so inherently frightening. If we can convince ourselves that we caused the threat to act the way it does we can maintain the secret hope that we can change it. Consequently, there is a tremendous attraction to blaming ourselves for the Islamic Enemy's behavior. And we see this power in our readily accepting responsibility for terror- because of our occupation, our greedy quest for oil, our failure to extend a hand of "engagement," Israel's building settlements, our making videos that defame Mohammed and so on. Again, the relationship is defined by the enemy blaming us for his actions and our accepting such responsibility.

Shelby Steele has written brilliantly about what he calls "white guilt" and outlines how whites during the 60′s and thereafter were pressured into a transaction whereby in order to re-obtain a sense of moral authority they accepted blame for the condition of blacks and behaved as if guilty. Blacks were able to extract great concessions and whites were able to view themselves as morally restored and redeemed. At a certain point, however, the behavior takes on a life of its own and the narratives become deeply embedded in the culture and, as we can see today, difficult to uproot.

Western guilt is an extension of Steele's notion. President Obama's confessionals to the Arab world admitting that America has made "mistakes" and was not born a colonial power express this same tendency to appease through guilt. Hillary Clinton's "reset" with Russia conveyed the same submissive request for a more acceptable response. In being guilty we presume the other party will recognize our contrition and respond in like kind. One of the Control Factor's most devastating moves is employed- presuming the other is just like us and will respond the way we would. This is frequently how an enabler justifies his continuous support for an addict. The problem, however is that our Islamic Enemy is NOT like us and will not respond in like kind.

Rather, as we repeatedly refuse to learn, appeasement invites more abuse from an enemy. This becomes the ”game of guilt;” it tends to expand to greater and greater consequences. Paradoxically, psychological defenses tend to create the very outcomes they seek to eliminate and it is no different here. It is a game we love to play but, unfortunately, the game gives us no rules for how to end it.

All behavior is instructive. That is, we teach others how to treat us. The game of guilt, along with other Control Factor tools, teaches our Enemy it is winning and to continue playing.

FP: The reason Nidal Hasan was able to perpetrate his murder spree at Fort Hood is precisely because of our Control Factor. Please connect the dots for our readers.

Siegel: Just as I used to look at Hitler when I was young and be amazed that no one could see what he was about, in retrospect the same applies to Hasan. It is precisely all the elements of the Control Factor that could allow this man, a Soldier of Allah, to be positioned as he was. He was blatantly voicing his Islamist views and Jihadi intent including, even, an essay recommending the “painful liquidation” of non-Muslims. Yet, in the Army of all places, the Control Factor operated to allow and even foster his work. Even after the murders, we continue the denial by calling it “workplace violence.” He is the Civilization-Violent Jihad combo! And we continue to enable the same infiltration elsewhere.

FP: Tell our readers about “The Project” and “Explanatory Memorandum.” These are realities that serve as great threats to the Control Factor, right?

Siegel: These are separate sets of documents that outline the Muslim Brotherhood’s goals and plans underlying the Civilization Jihad. The former was discovered in Europe and extends globally. The 1991 Explanatory Memorandum emerged in 2008 from the Holy Land Foundation trial and describes the Brotherhood’s work in America as a “Civilization-Jihadist Process with all the word means” and “a kind of grand Jihad in eliminating and destroying the Western civilization from within and ‘sabotaging’ its miserable house by their own hands and the hands of the believers so that it is eliminated and God’s religion is made victorious over all other religions.”

Much as the communists of the Soviet Union had formulated in the 1950s a detailed long term plan to destroy America (many of the effects of which we are seeing of late including destroying the nuclear family, secularizing the nation, feminizing men …) these documents identify many strategies to infiltrate while eroding the foundations of our civilization in order to transform it into an Islamic one. The Control Factor has many ingenious ways to convince us that this is ridiculous, that our courts and system would never allow such a thing, that one is racist or “Islamophobic,” if not insane, for even thinking this is real. And just as with the communists, time is plentiful. Even more so with our Islamic Enemy, a multi-decade plan is short term. It is not critical that a seriously engaged Muslim lives to see the result. It is critical, more correctly a duty, however, that he carries on his Jihad. Patrick Poole and The Center for Security Policy’s Team B Report, Shariah: The Threat to America, are excellent sources for your readers to pursue these documents.

FP: And so what you call an “Inner Jihad” has to start. It’s our, as you say, mandatory “addiction treatment.” Please explain.

Siegel: The “Inner Jihad” is the effort we must undertake to gain control over our Control Factors. There is a famous Hadith in which Mohammad, returning from a successful battle, essentially says that the physical fight was the “lesser Jihad” and it is time to then attend to the “greater Jihad・・・・・・癆・銓繝鈍・矚・跂・艨蝪齢・・・・・銓繝鈍・瘰鞜・・鵺・・・・・闔・・蝪謇鈑・鈔・・朓鶯莅・蓍跂・蓰・悲粡・・癈・繞・聲踈繻・・蛹蝴繖・・鱟・・癆・ぢ“Jihad” is not violent, it is useful to us as a symbol of the vicious effort we must take internally against our own Control Factor tendencies.

As I said earlier, the Control Factor is “active” and “continuous” so we must constantly monitor and combat it. Like “Whack-a-Mole,” just as we may think we have addressed it, another variation pops right up. I use the terms “addict” and “enabler” because we truly need a form of rehab to break the habitual power of the Control Factor and because our relationship with our Islamic Enemy is very much like that between a typical addict and his enabler. And just as it is so difficult for an addict to kick his habit, so does the enabler act essentially addicted to his behavior and find it so difficult to change. At its core, the relationship involves the transfer of responsibility for our Islamic Enemy's hate and resultant actions onto us with our response framed essentially as an effort to do what we can to try to address the Enemy's grievance. (Your book, United in Hate, describes this addiction to hate in detail.

The key to the Inner Jihad is to learn to transfer responsibility for our Islamic Enemy's hate and resultant actions back to it and take responsibility back for our own situation. We must learn all we can about the enemy. We must unwind our inappropriate projections and introjections and rediscover who we are and are not. We must speak up. We must support those Muslims who promote expressions of Islam that are consistent with our principles. And we must stalk the Control Factor, constantly be on guard for its intrusion. This is an individual endeavor as each of our Control Factors uses its own methods. The book gives plenty of examples of each maneuver discussed but it is important for each of us to discover the unique workings of his own mind. That takes the work of the Inner Jihad.

FP: Share with our readers what you mean by the "Turnaround Moment."

Siegel: There is a moment in typical horror films where the central characters have been pushed to their limit. They then change and fully embrace the willingness to be as ruthless as the threat they face. No more moral high ground; no more futile attempts to ignore or change the threat's essence. As Lee Harris described in The Suicide of Reason, it is the willingness or license to be (not necessarily actually being) as ruthless that is critical. It is a mental state that sheds all the prior counter-productive efforts at denial to finally clearly focus on the threat faced. Part of the Inner Jihad is to reach that Turnaround Moment sooner rather than later.

FP: You suggest that "mirroring" should be used as part of our arsenal. Tell us about it.

Siegel: Mirroring is a literal approach to transferring back to the addict responsibility that we have been inappropriately accepting. Critical to the addict/enabler relationship is asymmetry. Like the addict, the enemy uses a less limiting set of rules than we do. The enemy typically initiates aggression while we respond only. Mirroring means that we demonstrate our willingness to act symmetrically, to be governed by the same rules. It is stunning how much is accomplished when one's attitude simply is clear that he will do what is necessary; often not much else is needed as the addict or enemy realizes the game is fundamentally changed. But other times action is absolutely needed. Demonstrating that we are not afraid to treat the enemy as it treats us carries great meaning. Imagine (international law aside) if Israel announced that from now on it will mirror Hamas such that if civilian populations are targeted by bombs from Gaza, Israel will do the same (it is accused of such anyway). The population might finally rethink and take responsibility for its privilege of voting its leaders. As stated earlier, all behavior is instructive and when we mirror we teach the other the effects of his behavior.

Conversely, some situations demand that we assert asymmetry; those cases where it is necessary to highlight our differences with the enemy. Just this week, an disingenuous report was issued by an NGO drawing an equivalence between Palestinian and Israeli schoolbooks claiming that both sides have their relativistic " narratives." Yet, as the Palestinian Media Watch's website has demonstrated for years, there is nothing in the West anywhere comparable to the hatred spewed daily by the Palestinian Authority, including through its education system. It is interesting to note that while the US State Department initially funded the "study,"- in what appears to be an attempt to sanitize the PA's record so that the US can continue to fund the PA against the spirit of US law- Hillary Clinton has a difficult time escaping her conclusion as Senator in 2007 that these schoolbooks along with other media "profoundly poison(s) the minds of these children." It is most important that we do not succumb to this type of use of symmetry that distorts the profound differences between us and the enemy.

Essentially, we are not clear as a nation, participating in a world with international rules, how to best fight this enemy. The first act of any rehab is to acknowledge that we do not know how nor are we yet competent to stop our addictions. This is not a book about policy. In fact, the "right" policies are unlikely to emerge until a critical mass has meaningfully dealt with their Control Factors and share a common perspective. We like to look at our history and assume a single perspective throughout but the truth is that we had to learn how to respond to Pearl Harbor, the Nazis, the Cold War etc. The same applies here. Our press promotes "elites" who are tasked with acting as if they possess the "true wisdom" to deal with our threats but the truth is we do not know nor are we equipped to marshal enough of our population to agree just yet. The sooner we learn, however, the less we will suffer. Mirroring has always been a key component of those lessons.

I have been encouraged by some recent acts that have begun to nip at the asymmetry. For years, the language of "feelings" had been reserved for our enemy while we were limited to that of "action;" we would do terrible acts that would cause bad feelings in the enemy which would then serve to justify whatever response it made. It had always been a question of the harsh insensitive acts Westerners do against Muslims and the resulting hurt, loss, shame etc. that Muslims experience. The Ground Zero Mosque incident, however, broke new ground because all of a sudden non-Muslims' feelings became the focus and were cast as resulting from Muslim acts. Another example was seen in how quickly the attempt to blame the Benghazi murders on the video about Mohammad fell apart. Just as large corporations eventually learned to turn away from shakedown attempts from race baiters, we are beginning to learn to demand symmetry through mirroring. A word of caution: When enablers change their behavior and demand symmetrical rules for the addict, the latter typically initially erupts with great resistance. This is a stage we must be prepared to tolerate and fully withstand as it creates the only real chance for the addict to finally change. It is critical, therefore, that when we finally engage in mirroring that we be prepared to see it through completion.

FP: What if we fail to engage in our own Inner Jihad and the Control Factor stays firmly in place?

Siegel: Critical to the Inner Jihad is the realization that our civilization is fragile; not to be taken for granted. Our demands for multi-culturalism and diversity have bumped heads with the simple paradox that tolerating the intolerant leads to extinction. Tolerating the intolerant is perhaps the most crystalline version of asymmetry we have accepted. Seriously engaged Muslims MUST place the Koran above all law while in America, the Constitution ranks supreme. As Omar Ahmad , founder of CAIR, reputedly said, "Islam isn't in America to be equal to any other faith, but to become dominant. The Koran is the highest authority in America and Islam is the only accepted religion on Earth." Who makes law- the people or Allah? While the Control Factor constantly seeks for some accommodation between the two, this conflict CAN NOT be negotiated. Only one can survive not because we have declared "war" but because our Islamic Enemy has. That is, perhaps, the lesson we will most need to fully learn, one way or another. We will eventually hit a Turnaround Moment as a nation and if enough of us are not truly prepared to fight and continue to be controlled by our delusions, we will lose. If we truly seek to win, it is better to get there sooner while we have advantages than later.

FP: Bill Siegel, thank you for joining FrontPage Interview.

And thank you for writing this superb and most important book.

We encourage all of our readers to get their hands on The Control Factor: Our Struggle to See the True Threat and to read it!

Editor's note: To watch *The Glazov Gang*'s recent discussion about the Muslim Brotherhood's infiltration of the United States and the Obama administration, see this week's episode below:

Freedom Center pamphlets now available on Kindle: Click here.

Filed Under: Daily Mailer, FrontPage Tagged With: Denial, Islam, muslim brotherhood, Obama, Siegel, The Control Factor
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About Jamie Glazov

Jamie Glazov is Frontpage Magazine's editor. He holds a Ph.D. in History with a specialty in Russian, U.S. and Canadian foreign policy. He is the author of the critically acclaimed and best-selling, ***United in Hate: The Left's Romance with Tyranny and Terror.*** His new book is ***High No on For America.*** He is the host of Frontpage's television show, ***The Glazov Gang,*** and he can be reached at jamieglazov11@gmail.com. Visit his sit at ***JamieGlazov.com***.

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+3

AdinaK 86p · *11 hours ago*

The war being waged has two components - mental and physical. The mental side is a minefield of constructs, deeply implanted within generations of Americans, and its PC chickens are coming home to roost. So much so, millions of Americans (westerners) cannot break free of its shackles. But it is not as if these mental chains magically appe ared. Far from it - http://adinakutnicki.com/2012/11/26/the-death-of-...

In addition, the fault-lines of democracy allowed for the most retrograde forces, on this planet, to infiltrate and penetrate the body politic- http://adinakutnicki.com/2012/09/02/the-subversio...

IF the mental and physical constraints are not immediately removed, it is a given that western civilization will fall. Cause and effect.
Adina Kutnicki, Israel - http://adinakutnicki.com/about/
Report
Reply
1 reply · *active 30 minutes ago*
0

dmw · *30 minutes ago*

And I would think one "phy sical constraint" is to not let them in in the first place. By & quot;them" I mean those who have allegiance to a socio-political system disguised as a religion that seeks world dominance by man imposed methodology/effort -- unlike Judaism and Christianity properly understood. If we are to "believe", the world already has a King and does not need a Caliph.
Report
Reply
0

MikeWood · *6 hours ago*

Ground-breaking, brilliant. There are absolutely essentially lessons to be learned from this. Buy this book, read it, study it, and lend it to your friends and colleagues. Do it.
Report
Reply
0

lambsev77 54p · *4 hours ago*

The fall of Rome... The fall of the 3rd Reich... The fall of Western Civilization...

oooooh... Scary!

How about the fall of humankind recorded in Genesis Chapter 3 and following?

We're ALL GONNA DIE! But will you rise with Christ?
Report
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+1

5. Spam and advertising are not permitted in the comments area.
6. Impersonators will be banned immediately.

From: Bill Siegel [redacted]
Sent: 2/8/2013 8:10:04 PM
To: jeevacation@gmail.com
Subject: Re: Fro- The Control Factor - Frontpage Magazine interview
Attachments: image001.gif; image002.jpg; image003.png; image004.png; image005.jpg; image006.jpg; image007.png

Importance: High

You ok? I became friendly with shirley maclaine last year and went to her ranch in sante fe. I may go back and remembered you own half the ranch land there or something. Do you still like it there?

From: Jeffrey Epstein <jeevacation@gmail.com>
To: Bill Siegel
Sent: Fri Feb 08 14:58:01 2013
Subject: Re: Fro- The Control Factor - Frontpage Magazine interview

I already rad it. congragulations hope to see you soon

On Fri, Feb 8, 2013 at 3:40 PM, Bill Siegel <[redacted]> wrote:

> Bill Siegel hopes this might be of interest to you: http://frontpagemag.com/2013/jamie-glazov/the-control-factor-our-struggle-to-see-the-true-threat/
>
> # The Control Factor: Our Struggle to See the True Threat
>
> February 8, 2013 By Jamie Glazov Comments (6)
>
> 22
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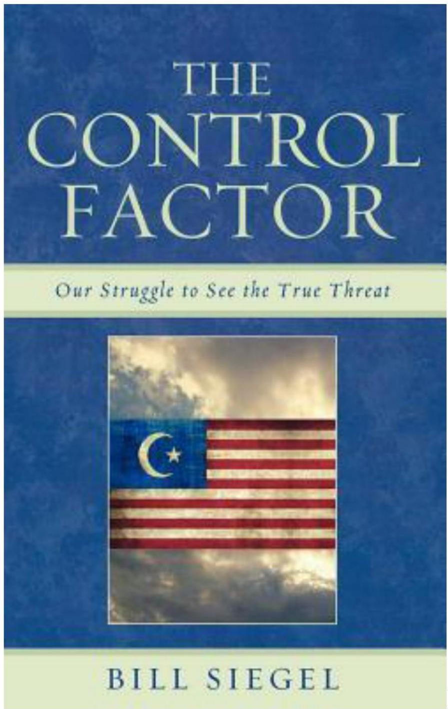
> Print This Post



FrontPage Interview's guest today is Bill Siegel, a lawyer and business executive. He has been a producer of several documentary films and assists numerous non-profit organizations. He is the author of The Control Factor: Our Struggle to See the True Threat.

FP: Bill Siegel, welcome to FrontPage Interview.

Congratulations on this brilliant book. It is without question one of the most vital works of our time.

Let's begin with what inspired you to write it.

Siegel: Thanks for having me Jamie. As a young boy born in the mid 1950s, I was fascinated with footage of Hitler and the Third Reich and could never understand how the Jews of the time could not see the evil that seemed so obvious. Not yet appreciative of the benefit of hindsight, I could not comprehend the blindness. Following 9/11, like so many others, I began to study Islam, its history, its current movements, terrorism and so on. As I would learn one stunning aspect after another, I would discuss them with friends and associates. Rather than confront the facts I would present, they would find one clever way after another to avoid the frightening truth of what America and the West truly face. Their fear appeared obvious to me. I began to catalog many of my friends' different maneuvers to dispel the anxiety that they found so difficult to endure. The more I focused on their mental processes (as well as my own) the more I began to see a structure to the mental endeavor and to understand what I had, as a child, found so difficult to explain.

FP: Tell us about the Control Factor, what you describe as "that effort our minds engage in in order to keep us blind" and that "process of avoiding seeing the threats we face." It's also about, as you state, trying to believe that the threat is under our control, when in fact it is not. Kindly enlighten us as to these profound insights you make in terms of the Control Factor.

Siegel: First, let's distinguish the "real world" where real battles are taking place from the mental battlefield which occurs in each of our minds. We tend to believe our perceptions are simply clear realizations of what is "out there" and overlook how much our internal worlds can literally determine what we see. When our internal minds become anxious and sense a loss of "control," they tend to concoct ways to distort our perceptions so as to restore that sense of inner control. I describe the Control Factor as an "active and continuous process" designed to maintain that sense, if not illusion, of control. We naturally think that our thinking and feeling processes are passive; that they just happen. Yet when faced with truly frightening prospects, the mind is geared to actively distort.

Similarly, the sense of control must be continuously maintained so the Control Factor operates constantly. In turn, the sum of this active and continuous undertaking makes these perceptions all the more familiar and thus seemingly all the more "real." In one sense, the Control Factor is the mechanism of what Andy McCarthy entitled one of his numerous excellent books- willful blindness. The Control Factor is cleverer than we are aware; that is almost tautological as, if our minds are to create ways to keep us in denial, they must out maneuver our conscious thinking.

Since World War II, America has had limited experience with threats coming to the homeland. Most of America's history has been about "over there," where we have always known that if things got too out of hand (e.g. Vietnam) we could always return home. The current generations, for a wide array of reasons, have had virtually no experience with a threat to this land. (The documentary, Generation Zero, is interesting on this point).

Consequently, the process of waking up to such a threat parallels the arc of a typical horror film. In such a film, there is typically a cast of characters surrounding one or two main characters. We in the audience know there is a threat coming – be it a monster, a virus, a psycho killer, an alien, the blob that ate Cincinnati etc. This threat is typically defined by its intent- the singular goal of destroying the characters. Much of the initial exposition shows how the characters first are oblivious to the destruction the threat brings about, then explain it in familiar terms only to finally open their eyes to see that something uniquely terrifying is happening. The next stage usually involves a series of failed attempts to deal with the threat- from trying to negotiate with it, to appease it, to coax it, to threaten it with ineffective weapons and so forth. Most of these failings are due to not adequately appreciating the threat for what it truly is and projecting onto it a host of other attributes instead. The final stage generally involves a back-up-against-the-wall decision by whichever characters remain alive. I named this the "turnaround moment" when the character becomes willing to be as ruthless as the threat. That change in mental state is necessary to ensure survival. Ultimately, the storyline is a race for whichever characters remain to wake up fully and use whatever advantages they may still have to beat the threat.

This is the same arc our minds go through in battling our own Control Factors, our own compulsions to deny that which is staring us in the face. Ultimately, the question is whether we will be able to wake up while we still have advantages and give ourselves permission to fully fight the battle we are in.

I said earlier that there is a structure to the Control Factor. To oversimplify, I view it much as a pyramid where on the bottom are the many minute by minute thoughts that are manipulated. I call this level of maneuvers the many "D's" as they include the psychological defenses such as distortion, denial, demonization, deflection, deletion, detachment, delusion, displacement, discolorization and so forth. Layered upon these are moves such as projection, where we can assign to our Islamic Enemy traits we wish to see in them or introject traits from them into ourselves that we wish not to acknowledge. These maneuvers involve a mixing of identities where we actually lose clarity about who we are and who the enemy is. Projection and introjection are active almost across the board. It is always helpful, for instance, to ask how what the enemy accuses us of is more appropriately descriptive of it. When we add Western Guilt and Shame, our need to be liked, and other psychological dimensions, basic thoughts solidify into larger fantasies.

As these narratives ("Our courts will never allow that," "As a superpower we will always be able to win any fight we put our minds to," "Assimilation will ensure Muslims are westernized" …) gain consent from others they tend to guide us deeply and become infused on our policies. Ultimately, what emerges is a relationship we take with our Islamic Enemy that parallels that between an addict and an enabler. Emblematic of this relationship is the "transfer of responsibility" in which we assume responsibility for the enemy's behavior who is addicted to transferring it away from itself. The Control Factor actively maintains this relationship and makes changing that relationship as difficult a chore as any addict finds in breaking his addiction. And just as an addict needs to devote serious effort and consciousness to his addiction, so must we devote great energy to understanding how the Control Factor ultimately sabotages us.

FP: Describe the threat we face in our Islamic enemy. And you talk about the three levels of jihad against us. What are they?

Siegel: Simply stated, our Islamic Enemy seeks the totalitarian domination of Islam throughout the world – Islamic supremacy. It seeks to have the West submit to Islam. Obviously, this does not mean that everybody becomes a Muslim. Islam, in all its varied expressions, permits dhimmis- those Christians, Jews, and some others who are permitted to remain as protected non-Muslims as long as they submit to an inferior status. What is critical is that Shariah (Islamic Law) ultimately rules the world.

Jihad, loosely, is the effort/struggle to see this vision through. The most obvious method of Jihad is through violence; it is the one most familiar to most Westerners and almost all of the Koranic references to Jihad are based in violence. The Violent Jihad includes al-Qaeda and its offshoots as well as other groups that formed around the globe independent of al-Qaeda. It also obviously includes the violence from Islamic nations such as the Islamic Republic of Iran whose constitution specifies such vision. It also includes, however, various militant groups and training camps here in the US as well as ad hoc efforts of individuals.

Since 9/11, there have been something in excess of 15,000 Violent Jihadic attacks across the globe. However, as terrible as this is, we have a tendency in the West to think that the only dimension of threat we face comes from violence. While the Bush administration helped initiate this thinking, the Obama administration has actively abused it by limiting any discussion of the threat we face to al-Qaeda and some other terrorist groups abroad. As frightening as these groups are, we can get some ease from thinking they are a band of "extremists limited in number, weaponry, sophistication, and means. Stunningly, Hillary Clinton recently estimated that there are only about 50,000 "homicidal" violent extremists around the world who simply have been able to project power much greater than their number should allow. Here the Control Factor makes the threat appear more easily manageable.

Jihad, however, is pursued in other often even more effective ways which I have grouped into three "levels." A second more insidious level of threat is what the Muslim Brotherhood itself called the "Civilization Jihad." It is the effort to infiltrate all aspects of our society, peacefully according to our laws, in order to later be in position to sabotage and destroy it from the inside. The Civilization Jihadists have learned the culture and rules of the territories they seek to command and use those rules to maneuver—specifically using our freedoms to destroy our freedoms. They use "lawfare" to seek changes in our laws so as to push Shariah into our society. Your readers should read Daniel Pipes and Brooke Goldstein's Lawfare Project material and others to fully appreciate how cancerous this activity has become. This includes intimidating in a variety of ways anyone who speaks out against them or Islam and seeking to squelch our treasured broad right to free speech so as to ultimately prevent any criticisms of Islam. Once criticism of Islam is prohibited, little can stop it from cascading throughout the culture.

The Civilization Jihad includes situating such Jihadists in critical positions in the society, in the government, in the legal system, the military, and elsewhere. It includes the control over university programs that distribute propaganda about Islam and Islamic history which then filters down throughout textbooks for even younger students. It includes control over most of the nation's mosques and local Imams guiding the messages engaged Muslims are receiving. Most troublesome are the Muslim groups (CAIR, ISNA, MSA and others associated and/or joint venture partners with the Muslim Brotherhood) supposedly interested in "outreach" which know how to appear Westernized and interested in the goals of Western Civilization. They have fooled a large part of our authorities and media due in part to their patience and willingness to chip away, one airport prayer room, one frivolous intimidating lawsuit, one Congressman or CIA officer, one mosque, one ruling at a time.

Particularly in the US, given our deep attachment to freedom as well as cultural and psychological tendencies toward diversity, Western guilt and expectations of truthfulness, this effort is devious and difficult to uproot. The Civilization Jihadists present one face to the American public which is completely at odds with their true agenda and how they deal in private. Jamie, you and David and others such as Steve Emerson, Frank Gaffney, Andy McCarthy and others have done so much to uncover this level of Jihad that your readers should be urged to review as much of their work (including Steve's recent excellent documentary, The Grand Deception, and Frank's important web video course, The Muslim Brotherhood in America) as possible.

Finally, there is a third level – the International Institutional Jihad. Here the most powerful international institutions such as the UN and the Organization of Islamic Cooperation and others seek to push into America from without those changes which are difficult to complete from within. The OIC is the largest Islamic institution in the world. It essentially controls the vote in the UN's General Assembly and thus explains in part the absurd and abject pro-Islamic, anti-Israel thrust of that organizat ion. This level seeks to use the power of Islamic nations to work fro m outside the West to force changes within the West. While there are various conflicts between many of the nations, being Islamic majority states, there is a great deal they agree upon which becomes the focus of these efforts. Just as the Obama administration is beginning to cooperate with international efforts to control gun ownership, so has Hillary Clinton's Istanbul Process become a dangerous step in the effort to restrict speech critical of Islam by norm (or possibly even treaty) when it may not be fully executable by domestic action alone.

I should point out that Stephen Coughlin, the former Pentagon officer who has an important must-see presentation of Islamic Law, uses different names for these same three levels – Jihad, Dawa, and Ummah. Had I seen his work before I wrote my book I would have conformed to his categorizations.

We must learn how powerful language has become on all three levels. Words such as "peace,� $B!I "freedom," "terrorism," and phrases such as "human rights" have different meanings for us and for our Islamic Enemy. To oversimplify, "peace" is not something for now but that which comes when all the earth is submitting to Islam. In the context of battles, "peace" is at best a temporary ceasefire. "Freedom" is best understood as having the freedom to fully submit to Islam, not to choose whatever beliefs one desires while respecting the same right in others. We've all seen how "human rights" and "terror" really only apply among Muslims, not to non-Muslims. Our enemy fully understands these differences and uses them at all levels to paralyze us.

Look simply at how the phrase "Israeli-Palestinian conflict" has equalized the two parties, making it all the easier to ascribe features of one to the other and view the problem as a simple-to fix division of ass ets into statehoods but for personality problems among the leaders. The simple truth is that this is and has always been a one-sided Arab war against Israel as Ruth Wisse and others have described and, as Bibi Netanyahu made clear, the ONLY state truly at issue here has been the State of Israel that the Arabs have refused for over half a century. Nonetheless, the Control Factor hypnotically abuses the mind's susceptibility to the intricacies of language.

Even the label "Peace Process" has been damaging language. While most focus upon the first word, turning this into a "process" has helped ensure that peace is never obtained. It is more appropriately called the "Extortion Process" because all that results is that violence is used over decades to extract concessions from Israel.

These three levels must be understood for their differences while united by a single goal. While these levels often op erate together and assist each other, we must avoid "level confusion" which the Control Factor employs to curtail our fears. If the Obama narrative is swallowed- that the only threat is the Violent Jihad- we will miss the other contamination fomenting within our borders. We must appreciate how these levels work together and even unite with other forces such as the global Leftist movement that you, Jamie, have described so forcefully in United in Hate.

FP: You write about how we like to talk of "Good Muslims" and how we are always on the eternal search for "moderate" Muslims (Khatami, Mousavi, Abbas, etc), while we stress how the "extremists" are the real problem and how "f ew" they really are. All of this is connected to the Control F actor. Enlighten us.

Siegel: The Control Factor seeks to have us feel in control of the situation. The easiest way to do this is to simply minimize the number of potential enemies. We have been lectured for years about how Islam is a "religion of peace" and that the violence we see (remember that we have already improperly limited the problem to violence) is the product of a small number of "crazies" (remember Hillary Clinton's 50,000) who have distorted Islam. I call this the "Peaceful Muslim Disclaimer" as virtually everyone in the press and government has been bullied into making some statement of the kind to silence those who will pressure them that they are "Islamophobic" and Islam is being attacked. (These are the Islam hustlers who operate on the same principles that black race hustlers so effectively used to extort concessions over the last six decades or so).

Nobody has done any real work to support this proposition, nor is it clear exactly how it would be tested. My view is that the grammar “Islam is x” is itself problematic because Islam has expressed itself throughout history in a variety of fashions. It is more useful to talk in terms of how seriously engaged with Islam, the Koran and other texts, a Muslim is. What is significant is how Muslims today are using Islam and most of those who are in power either throughout a large territory or within a small community tend toward, if not fully advocate, the very supremacist ideas that we try to tell ourselves are reserved for the few ”extremists.” Presumably most Germans did not wish to see all Nazi atrocities carried out but in the end they fell in line because they had to. Those our politicians and press call the “extremists” are in one sense more accurately the “good” Muslims who ar e following their Islamic beliefs dutifully.

FP: Tell us how Western shame and guilt play into all of this.

Siegel: One of the dirty little secrets the Control Factor preys upon is that if we believe we control something we can comfort ourselves that we can change it. Remember the horror film- the threat has one purpose and that is to destroy you. You can not change it, talk it out of it, teach it alternatives or otherwise. That is what makes it so inherently frightening. If we can convince ourselves that we caused the threat to act the way it does we can maintain the secret hope that we can change it. Consequently, there is a tremendous attraction to blaming ourselves for the Islamic Enemy’s behavior. And we see this power in our readily accepting responsibility for terror- because of our occupation, our greedy quest for oil, our failure to extend a hand of “engagement,” Israel’s building settlements, our making videos that defa me Mohammed and so on. Again, the relationship is defined by the enemy blaming us for his actions and our accepting such responsibility.

Shelby Steele has written brilliantly about what he calls “white guilt” and outlines how whites during the 60′s and thereafter were pressured into a transaction whereby in order to re-obtain a sense of moral authority they accepted blame for the condition of blacks and behaved as if guilty. Blacks were able to extract great concessions and whites were able to view themselves as morally restored and redeemed. At a certain point, however, the behavior takes on a life of its own and the narratives become deeply embedded in the culture and, as we can see today, difficult to uproot.

Western guilt is an extension of Steele’s notion. President Obama’s confessionals to the Arab world admitting that America has made “mistakes” and was not born a colonial pow er express this same tendency to appease through guilt. Hillary Clint on’s “reset” with Russia conveyed the same submissive request for a more acceptable response. In being guilty we presume the other party will recognize our contrition and respond in like kind. One of the Control Factor’s most devastating moves is employed- presuming the other is just like us and will respond the way we would. This is frequently how an enabler justifies his continuous support for an addict. The problem, however is that our Islamic Enemy is NOT like us and will not respond in like kind. Rather, as we repeatedly refuse to learn, appeasement invites more abuse from an enemy. This becomes the ”game of guilt;” it tends to expand to greater and greater consequences. Paradoxically, psychological defenses tend to create the very outcomes they seek to eliminate and it is no different here. It is a game we love to play but, unfortunately, the game gives us no rules for how to end it.

All beha vior is instructive. That is, we teach others how to treat us. The game of guilt, along with other Control Factor tools, teaches our Enemy it is winning and to continue playing.

FP: The reason Nidal Hasan was able to perpetrate his murder spree at Fort Hood is precisely because of our Control Factor. Please connect the dots for our readers.

Siegel: Just as I used to look at Hitler when I was young and be amazed that no one could see what he was about, in retrospect the same applies to Hasan. It is precisely all the elements of the Control Factor that could allow this man, a Soldier of Allah, to be positioned as he was. He was blatantly voicing his Islamist views and Jihadi intent including, even, an essay recommending the “painful liquidation” of non-Muslims. Yet, in the Army of all places, the Control Factor operated to allow and even foster his work. Even after the murders, we cont inue the denial by calling it “workplace violence.” He is the Civilization-Violent Jihad combo! And we continue to enable the same infiltration elsewhere.

FP: Tell our readers about “The Project” and “Explanatory Memorandum.” These are realities that serve as great threats to the Control Factor, right?

Siegel: These are separate sets of documents that outline the Muslim Brotherhood's goals and plans underlying the Civilization Jihad. The former was discovered in Europe and extends globally. The 1991 Explanatory Memorandum emerged in 2008 from the Holy Land Foundation trial and describes the Brotherhood's work in America as a "Civilization-Jihadist Process with all the word means" and "a kind of grand Jihad in eliminating and destroying the Western civilization from within and 'sabotaging' its miserable house by their own hands and the hands of the believers so that it is eliminated and God's religion is made victorious over all other religions."

Much as the communists of the Soviet Union had formulated in the 1950s a detailed long term plan to destroy America (many of the effects of which we are seeing of late including destroying the nuclear family, secularizing the nation, feminizing men …) these documents identify many strategies to infiltrate while eroding the foundations of our civilization in order to transform it into an Islamic one. The Control Factor has many ingenious ways to convince us that this is ridiculous, that our courts and system would never allow such a thing, that one is racist or "Islamophobic," if not insane, for even thinking this is real. And just as with the communists, time is plentiful. Even more so with our Islamic Enemy, a multi-decade plan is short term. It is not critical that a serious ly engaged Muslim lives to see the result. It is critical, more correctly a duty, however, that he carries on his Jihad. Patrick Poole and The Center for Security Policy's Team B Report, Shariah: The Threat to America, are excellent sources for your readers to pursue these documents.

FP: And so what you call an "Inner Jihad" has to start. It's our, as you say, mandatory "addiction treatment." Please explain.

Siegel: The "Inner Jihad" is the effort we must undertake to gain control over our Control Factors. There is a famous Hadith in which Mohammad, returning from a successful battle, essentially says that the physical fight was the "lesser Jihad" and it is time to then attend to the "greater Jihad �"- that internal battle against our own internal appetites, lusts, wrong thinking and so forth. While that Hadith has been falsely utilized to say that "Jihad" is not violent, it is useful to us as a symbol of the vicious effort we must take internally against our own Control Factor tendencies.

As I said earlier, the Control Factor is "active" and "continuous" so we must constantly monitor and combat it. Like "Whack-a-Mole," just as we may think we have addressed it, another variation pops right up. I use the terms "addict" and "enabler" because we truly need a form of rehab to break the habitual power of the Control Factor and because our relationship with our Islamic Enemy is very much like that between a typical addict and his enabler. And just as it is so difficult for an addict to kick his habit, so does the enabler act essentially addicted to his behavior and find it so difficult to change. At its core, the relati onship involves the transfer of responsibility for our Islamic Enemy's hate and resultant actions onto us with our response framed essentially as an effort to do what we can to try to address the Enemy's grievance. (Your book, United in Hate, describes this addiction to hate in detail.

The key to the Inner Jihad is to learn to transfer responsibility for our Islamic Enemy's hate and resultant actions back to it and take responsibility back for our own situation. We must learn all we can about the enemy. We must unwind our inappropriate projections and introjections and rediscover who we are and are not. We must speak up. We must support those Muslims who promote expressions of Islam that are consistent with our principles. And we must stalk the C ontrol Factor, constantly be on guard for its intrusion. This is an individual endeavor as each of our Control Factors uses its own methods. The book gives plenty of examples of each maneuver discussed but it is important for each of us to discover the unique workings of his own mind. That takes the work of the Inner Jihad.

FP: Share with our readers what you mean by the "Turnaround Moment."

Siegel: There is a moment in typical horror films where the central characters have been pushed to their limit. They then change and fully embrace the willingness to be as ruthless as the threat they face. No more moral high ground; no more futile attempts to ignore or change the threat's essence. As Lee Harris described in The Suicide of Reason, it is the willingness o r license to be (not necessarily actually being) as ruthless that is critical. It is a mental state that sheds all the prior counter-productive efforts at denial to finally clearly focus on the threat faced. Part of the Inner Jihad is to reach that Turnaround Moment sooner rather than later.

FP: You suggest that "mirroring" should be used as part of our arsenal. Tell us about it.

Siegel: Mirroring is a literal approach to transferring back to the addict responsibility that we have been inappropriately accepting. Critical to the addict/enabler relationship is asymmetry. Like the addict, the enemy uses a less limiting set of rules than we do. The enemy typically initiates aggression while we respond only. Mirroring means that we demonstrate our willingness to act symmetrically, to be governed by the same rules. It is stunning how much is accomplished when one's attitude simply is clear that he will do what is necessary; often not much else is needed as the addict or enemy realizes the game is fundamentally changed. But other times action is absolutely needed. Demonstrating that we are not afraid to treat the enemy as it treats us carries great meaning. Imagine (international law aside) if Israel announced that from now on it will mirror Hamas such that if civilian populations are targeted by bombs from Gaza, Israel will do the same (it is accused of such anyway). The population might finally rethink and take responsibility for its privilege of voting its leaders. As stated earlier, all behavior is instructive and when we mirror we teach the other the effects of his behavior.

Conversely, some situations demand that we assert asymmetry; those cases where it is necessary to highlight our differences with the enemy. Just this week, an disingenuous report was issued by an NGO drawing an equivalence between Palestinian and Israeli schoolbooks claiming that both sides have their relativistic " narratives." Yet, as the Palestinian Media Watch's website has demonstrated for years, there is nothing in the West anywhere comparable to the hatred spewed daily by the Palestinian Authority, including through its education system. It is interesting to note that while the US State Department initially funded the "study,"- in what appears to be an attempt to sanitize the PA's record so that the US can continue to fund the PA against the spirit of US law- Hillary Clinton has a difficult time escaping her conclusion as Senator in 2007 that these schoolbooks along with other media "profoundly poison(s) the minds of these children." It is most important that we do not succumb to this type of use of symmetry that distorts the profound differences between us and the enemy.

Essentially, we are not clear as a nation, participating in a world with international rules, how to best fight this enemy. The first act of any rehab is to acknowledge that we do not know how nor are we yet competent to stop our addictions. This is not a book about policy. In fact, the "right" policies are unlikely to emerge until a critical mass has meaningfully dealt with their Control Factors and share a common perspective. We like to look at our history and assume a single perspective throughout but the truth is that we had to learn how to respond to Pearl Harbor, the Nazis, the Cold War etc. The same applies here. Our press promotes "elites" who are tasked with acting as if they possess the "true wisdom" to deal with our threats but the truth is we do not know nor are we equipped to marshal enough of our population to agree just yet. The sooner we learn, however, the less we will suffer. Mirroring has always been a key component of those lessons.

I have been encouraged by some recent acts that have begun to nip at the asymmetry. For years, the language of "feelings" had been reserved for our enemy while we were limited to that of "action;" we would do terrible acts that would cause bad feelings in the enemy which would then serve to justify whatever response it made. It had always been a question of the harsh insensitive acts Westerners do against Muslims and the resulting hurt, loss, shame etc. that Muslims experience. The Ground Zero Mosque incident, however, broke new ground because all of a sudden non-Muslims' feelings became the focus and were cast as resulting from Muslim acts. Another example was seen in how quickly the attempt to blame the Benghazi murders on the video about Mohammad fell apart. Just as large corporations eventually learned to turn away from shakedown attempts from race baiters, we are beginning to learn to demand symmetry through mirroring. A word of caution: When enablers change their behavior and demand symmetrical rules for the addict, the latter typically initially erupts with great resistance. This is a stage we must be prepared to tolerate and fully withstand as it creates the only real chance for the addict to finally change. It is critical, therefore, that when we finally engage in mirroring that we be prepared to see it through completion.

FP: What if we fail to engage in our own Inner Jihad and the Control Factor stays firmly in place?

Siegel: Critical to the Inner Jihad is the realization that our civilization is fragile; not to be taken for granted. Our demands for multi-culturalism and diversity have bumped heads with the simple paradox that tolerating the intolerant leads to extinction. Tolerating the intolerant is perhaps the most crystalline version of asymmetry we have accepted. Seriously engaged Muslims MUST place the Koran above all law while in America, the

Constitution ranks supreme. As Omar Ahmad , founder of CAIR, reputedly said, “Islam isn’t in America to be equal to any other faith, but to become dominant. The Koran is the highest authority in America and Islam is the only accepted religion on Earth.” Who makes law- the people or Allah? While the Control Factor constantly seeks for some accommodation between the two, this conflict CAN NOT be negotiated. Only one can survive not because we have declared “war” but because our Islamic Enemy has. That is, perhaps, the lesson we will most need to fully learn, one way or another. We will eventually hit a Turnaround Moment as a nation and if enough of us are not truly prepared to fight and continue to be controlled by our delusions, we will lose. If we truly seek to win, it is better to get there sooner while we have advantages than later.

FP: Bill Siegel, thank you for joining FrontPage Interview.

And thank you for writing this superb and most important book.

We encourage all of our readers to get their hands on The Control Factor: Our Struggle to See the True Threat and to read it!

Editor’s note: To watch *The Glazov Gang*‘s recent discussion about the Muslim Brotherhood’s infiltration of the United States and the Obama administration, see this week’s episode below:

Freedom Center pamphlets now available on Kindle: Click here.

Filed Under: Daily Mailer, FrontPage Tagged With: Denial, Islam, muslim brotherhood, Obama, Siegel, The Control Factor

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About Jamie Glazov

Jamie Glazov is Frontpage Magazine's editor. He holds a Ph.D. in History with a specialty in Russian, U.S. and Canadian foreign policy. He is the author of the critically acclaimed and best-selling, ***United in Hate: The Left’s Romance with Tyranny and Terror.*** His new book is ***High No on For America.*** He is the host of Frontpage’s television show, ***The Glazov Gang,*** and he can be reached at jamieglazov11@gmail.com. Visit his sit at ***JamieGlazov.com***.

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AdinaK 86p · *11 hours ago*

The war being waged has two components - mental and physical. The mental side is a minefield of constructs, deeply implanted within generations of Americans, and its PC chickens are coming home to roost. So much so, millions of Americans (westerners) cannot break free of its shackles. But it is not as if these mental chains magically appeared. Far from it - http://adinakutnicki.com/2012/11/26/the-death-of-...

In addition, the fault-lines of democracy allowed for the most retrograde forces, on this planet, to infiltrate and penetrate the body politic- http://adinakutnicki.com/2012/09/02/the-subversio...

IF the mental and physical constraints are not immediately removed, it is a given that western civilization will fall. Cause and effect.
Adina Kutnicki, Israel - http://adinakutnicki.com/about/

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@WolfyJam · *2 hours ago*

I read the Control factor and it was excellent. I wish more people would realize that our country is at its most vulnerable than ever in its history. the jihadis have basically taken over the inner cities. Islam's love for violence coupled with ignorance and narcissim are a recipe for disaster. I hope Americans wake up in time to save their future. I'm not optimistic though. I think its over but still I fight on.

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From: Bill Siegel [[redacted]
Sent: 2/8/2013 8:48:50 PM
To: jeevacation@gmail.com
Subject: Re: Fro- The Control Factor - Frontpage Magazine interview
Attachments: image001.gif; image002.jpg; image003.png; image004.png; image005.jpg; image006.jpg; image007.png

Importance: High

I will let you know when I go back. Do you know her?

From: Jeffrey Epstein <jeevacation@gmail.com>
To: Bill Siegel
Sent: Fri Feb 08 15:16:44 2013
Subject: Re: Fro- The Control Factor - Frontpage Magazine interview

great. place.. when will you go.. did you get married? i m between alber and santa fe,, zorrro ranch, you can google earth it.

On Fri, Feb 8, 2013 at 4:10 PM, Bill Siegel <[redacted]> wrote:

> You ok? I became friendly with shirley maclaine last year and went to her ranch in sante fe. I may go back and remembered you own half the ranch land there or something. Do you still like it there?
>
> ---
>
> **From:** Jeffrey Epstein <jeevacation@gmail.com>
> **To:** Bill Siegel
> **Sent:** Fri Feb 08 14:58:01 2013
> **Subject:** Re: Fro- The Control Factor - Frontpage Magazine interview
>
> I already rad it. congragulations hope to see you soon
>
> On Fri, Feb 8, 2013 at 3:40 PM, Bill Siegel <[redacted]> wrote:
>
>> Bill Siegel hopes this might be of interest to you: http://frontpagemag.com/2013/jamie-glazov/the-control-factor-our-struggle-to-see-the-true-threat/
>>
>> # The Control Factor: Our Struggle to See the True Threat
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>> February 8, 2013 By Jamie Glazov Comments (6)
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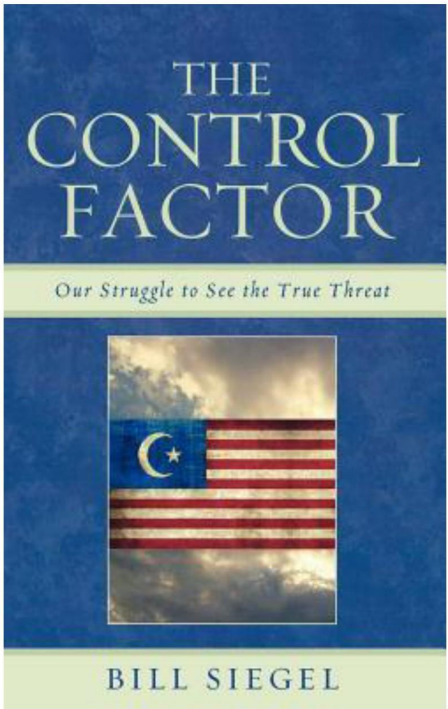

FrontPage Interview's guest today is Bill Siegel, a lawyer and business executive. He has been a producer of several documentary films and assists numerous non-profit organizations. He is the author of The Control Factor: Our Struggle to See the True Threat.

FP: Bill Siegel, welcome to FrontPage Interview.

Congratulations on this brilliant book. It is without question one of the most vital works of our time.

Let's begin with what inspired you to write it.

Siegel: Thanks for having me Jamie. As a young boy born in the mid 1950s, I was fascinated with footage of Hitler and the Third Reich and could never understand how the Jews of the time could not see the evil that seemed so obvious. Not yet appreciative of the benefit of hindsight, I could not comprehend the blindness. Following 9/11, like so many others, I began to study Islam, its history, its current movements, terrorism and so on. As I would learn one stunning aspect after another, I would discuss them with friends and associates. Rather than confront the facts I would present, they would find one clever way after another to avoid the frightening truth of what America and the West truly face. Their fear appeared obvious to me. I began to catalog many of my friends' different maneuvers to dispel the anxiety that they found so difficult to endure. The more I focused on their mental processes (as well as my own) the more I began to see a structure to the mental endeavor and to understand what I had, as a child, found so difficult to explain.

FP: Tell us about the Control Factor, what you describe as "that effort our minds engage in in order to keep us blind" and that "process of a voiding seeing the threats we face." It's also about, as you state, trying to believe that the threat is under our control, when in fact it is not. Kindly enlighten us as to these profound insights you make in terms of the Control Factor.

Siegel: First, let's distinguish the "real world" where real battles are taking place from the mental battlefield which occurs in each of our minds. We tend to believe our perceptions are simply clear realizations of what is "out there" and overlook how much our internal worlds can literally determine what we see. When our internal minds become anxious and sense a loss of "control," they tend to concoct ways to distort our perceptions so as to restore that sense of inner control. I describe the Control Factor as an "active and continuous process" designed to maintain that sense, if not illusion, of control. We naturally think that our thinking and feeling processes are passive; that they just happen. Yet when faced with truly frightening prospects, the mind is geared to actively distort.

Similarly, the sense of control must be continuously maintained so the Control Factor operates constantly. In turn, the sum of this active and continuous undertaking makes these perceptions all the more familiar and thus seemingly all the more "real." In one sense, the Control Factor is the mechanism of what Andy McCarthy entitled one of his numerous excellent books- willful blindness. The Control Factor is cleverer than we are aware; that is almost tautological as, if our minds are to create ways to keep us in denial, they must out maneuver our conscious thinking.

Since World War II, America has had limited experience with threats coming to the homeland. Most of America's history has been about "over there," where we have always known that if things got too out of hand (e.g. Vietnam) we could always return home. The current generations, for a wide array of reasons, have had virtually no experience with a threat to this land. (The documentary, Generation Zero, is interesting on this point).

Consequently, the process of waking up to such a threat parallels the arc of a typical horror film. In such a film, there is typically a cast of characters surrounding one or two main characters. We in the audience know there is a threat coming – be it a monster, a virus, a psycho killer, an alien, the blob that ate Cincinnati etc. This threat is typically defined by its intent- the singular goal of destroying the characters. Much of the initial exposition shows how the characters first are oblivious to the destruction the threat brings about, then explain it in familiar terms only to finally open their eyes to see that something uniquely terrifying is happening. The next stage usually involves a series of failed attempts to deal with the threat- from trying to negotiate with it, to appease it, to coax it, to threaten it with ineffective weapons and so forth. Most of these failings are due to not adequately appreciating the threat for what it truly is and projecting onto it a host of other attributes instead. The final stage generally involves a back-up-against-the-wall decision by whichever characters remain alive. I named this the "turnaround moment" when the character becomes willing to be as ruthless as the threat. That change in mental state is necessary to ensure survival. Ultimately, the storyline is a race for whichever characters remain to wake up fully and use whatever advantages they may still have to beat the threat.

This is the same arc our minds go through in battling our own Control Factors, our own compulsions to deny that which is staring us in the face. Ultimately, the question is whether we will be able to wake up while we still have advantages and give ourselves permission to fully fight the battle we are in.

I said earlier that there is a structure to the Control Factor. To oversimplify, I view it much as a pyramid where on the bottom are the many minute by minute thoughts that are manipulated. I call this level of maneuvers the many "D's" as they include the psychological defenses such as distortion, denial, demonization, deflection, deletion, detachment, delusion, displacement, discolorization and so forth. Layered upon these are moves such as projection, where we can assign to our Islamic Enemy traits we wish to see in them or introject traits from them into ourselves that we wish not to acknowledge. These maneuvers involve a mixing of identities where we actually lose clarity about who we are and who the enemy is. Projection and introjection are active almost across the board. It is always helpful, for instance, to ask how what the enemy accuses us of is more appropriately descriptive of it. When we add Western Guilt and Shame, our need to be liked, and other psychological dimensions, basic thoughts solidify into larger fantasies.

As these narratives ("Our courts will never allow that," "As a superpower we will always be able to win any fight we put our minds to," "Assimilation will ensure Muslims are westernized" …) gain consent from others they tend to guide us deeply and become infused on our policies. Ultimately, what emerges is a relationship we take with our Islamic Enemy that parallels that between an addict and an enabler. Emblematic of this relationship is the "transfer of responsibility" in which we assume responsibility for the enemy's behavior who is addicted to transferring it away from itself. The Control Factor actively maintains this relationship and makes changing that relationship as difficult a chore as any addict finds in breaking his addiction. And just as an addict needs to devote serious effort and consciousness to his addiction, so must we devote great energy to understanding how the Control Factor ultimately sabotages us.

FP: Describe the threat we face in our Islamic enemy. And you talk about the three levels of jihad against us. What are they?

Siegel: Simply stated, our Islamic Enemy seeks the totalitarian domination of Islam throughout the world – Islamic supremacy. It seeks to have the West submit to Islam. Obviously, this does not mean that everybody becomes a Muslim. Islam, in all its varied expressions, permits dhimmis- those Christians, Jews, and some others who are permitted to remain as protected non-Muslims as long as they submit to an inferior status. What is critical is that Shariah (Islamic Law) ultimately rules the world.

Jihad, loosely, is the effort/struggle to see this vision through. The most obvious method of Jihad is through violence; it is the one most familiar to most Westerners and almost all of the Koranic references to Jihad are based in violence. The Violent Jihad includes al-Qaeda and its offshoots as well as other groups that formed around the globe independent of al-Qaeda. It also obviously includes the violence from Islamic nations such as the Islamic Republic of Iran whose constitution specifies such vision. It also includes, however, various militant groups and training camps here in the US as well as ad hoc efforts of individuals.

Since 9/11, there have been something in excess of 15,000 Violent Jihadic attacks across the globe. However, as terrible as this is, we have a tendency in the West to think that the only dimension of threat we face comes from violence. While the Bush administration helped initiate this thinking, the Obama administration has actively abused it by limiting any discussion of the threat we face to al-Qaeda and some other terrorist groups abroad. As frightening as these groups are, we can get some ease from thinking they are a band of "extremists limited in number, weaponry, sophistication, and means. Stunningly, Hillary Clinton recently estimated that there are only about 50,000 "homicidal" violent extremists around the world who simply have been able to project power much greater than their number should allow. Here the Control Factor makes the threat appear more easily manageable.

Jihad, however, is pursued in other often even more effective ways which I have grouped into three "levels." A second more insidious level of threat is what the Muslim Brotherhood itself called the "Civilization Jihad." It is the effort to infiltrate all aspects of our society, peacefully according to our laws, in order to later be in position to sabotage and destroy it from the inside. The Civilization Jihadists have learned the culture and rules of the territories they seek to command and use those rules to maneuver—specifically using our freedoms to destroy our freedoms. They use "lawfare" to seek changes in our laws so as to push Shariah into our society. Your readers should read Daniel Pipes and Brooke Goldstein's Lawfare Project material and others to fully appreciate how cancerous this activity has become. This includes intimidating in a variety of ways anyone who speaks out against them or Islam and seeking to squelch our treasured broad right to free speech so as to ultimately prevent any criticisms of Islam. Once criticism of Islam is prohibited, little can stop it from cascading throughout the culture.

The Civilization Jihad includes situating such Jihadists in critical positions in the society, in the government, in the legal system, the military, and elsewhere. It includes the control over university programs that distribute propaganda about Islam and Islamic history which then filters down throughout textbooks for even younger students. It includes control over most of the nation's mosques and local Imams guiding the messages engaged Muslims are receiving. Most troublesome are the Muslim groups (CAIR, ISNA, MSA and others associated and/or joint venture partners with the Muslim Brotherhood) supposedly interested in "outreach" which know how to appear Westernized and interested in the goals of Western Civilization. They have fooled a large part of our authorities and media due in part to their patience and willingness to chip away, one airport prayer room, one frivolous intimidating lawsuit, one Congressman or CIA officer, one mosque, one ruling at a time.

Particularly in the US, given our deep attachment to freedom as well as cultural and psychological tendencies toward diversity, Western guilt and expectations of truthfulness, this effort is devious and difficult to uproot. The Civilization Jihadists present one face to the American public which is completely at odds with their true agenda and how they deal in private. Jamie, you and David and others such as Steve Emerson, Frank Gaffney, Andy McCarthy and others have done so much to uncover this level of Jihad that your readers should be urged to review as much of their work (including Steve's recent excellent documentary, The Grand Deception, and Frank's important web video course, The Muslim Brotherhood in America) as possible.

Finally, there is a third level – the International Institutional Jihad. Here the most powerful international institutions such as the UN and the Organization of Islamic Cooperation and others seek to push into America from without those changes which are difficult to complete from within. The OIC is the largest Islamic institution in the world. It essentially controls the vote in the UN’s General Assembly and thus explains in part the absurd and abject pro-Islamic, anti-Israel thrust of that organization. This level seeks to use the power of Islamic nations to work from outside the West to force changes within the West. While there are various conflicts between many of the nations, being Islamic majority states, there is a great deal they agree upon which becomes the focus of these efforts. Just as the Obama administration is beginning to cooperate with international efforts to control gun ownership, so has Hillary Clinton’s Istanbul Process become a dangerous step in the effort to restrict speech critical of Islam by norm (or possibly even treaty) when it may not be fully executable by domestic action alone.

I should point out that Stephen Coughlin, the former Pentagon officer who has an important must-see presentation of Islamic Law, uses different names for these same three levels – Jihad, Dawa, and Ummah. Had I seen his work before I wrote my book I would have conformed to his categorizations.

We must learn how powerful language has become on all three levels. Words such as “peace,� $B!I “freedom,” ”terrorism,” and phrases such as “human rights” have different meanings for us and for our Islamic Enemy. To oversimplify, “peace” is not something for now but that which comes when all the earth is submitting to Islam. In the context of battles, “peace” is at best a temporary ceasefire. “Freedom” is best understood as having the freedom to fully submit to Islam, not to choose whatever beliefs one desires while respecting the same right in others. We’ve all seen how ”human rights” and “terror” really only apply among Muslims, not to non-Muslims. Our enemy fully understands these differences and uses them at all levels to paralyze us.

Look simply at how the phrase “Israeli-Palestinian conflict” has equalized the two parties, making it all the easier to ascribe features of one to the other and view the problem as a simple-to fix division of assets into statehoods but for personality problems among the leaders. The simple truth is that this is and has always been a one-sided Arab war against Israel as Ruth Wisse and others have described and, as Bibi Netanyahu made clear, the ONLY state truly at issue here has been the State of Israel that the Arabs have refused for over half a century. Nonetheless, the Control Factor hypnotically abuses the mind’s susceptibility to the intricacies of language.

Even the label “Peace Process” has been damaging language. While most focus upon the first word, turning this into a “process” has helped ensure that peace is never obtained. It is more appropriately called the “Extortion Process” because all that results is that violence is used over decades to extract concessions from Israel.

These three levels must be understood for their differences while united by a single goal. While these levels often operate together and assist each other, we must avoid “level confusion” which the Control Factor employs to curtail our fears. If the Obama narrative is swallowed- that the only threat is the Violent Jihad- we will miss the other contamination fomenting within our borders. We must appreciate how these levels work together and even unite with other forces such as the global Leftist movement that you, Jamie, have described so forcefully in United in Hate.

FP: You write about how we like to talk of “Good Muslims” and how we are always on the eternal search for “moderate” Muslims (Khatami, Mousavi, Abbas, etc), while we stress how the “extremists” are the real problem and how “few” they really are. All of this is connected to the Control Factor. Enlighten us.

Siegel: The Control Factor seeks to have us feel in control of the situation. The easiest way to do this is to simply minimize the number of potential enemies. We have been lectured for years about how Islam is a “religion of peace” and that the violence we see (remember that we have already improperly limited the problem to violence) is the product of a small number of “crazies” (remember Hillary Clinton’s 50,000) who have distorted Islam. I call this the “Peaceful Muslim Disclaimer” as virtually everyone in the press and government has been bullied into making some statement of the kind to silence those who will pressure them that they are “Islamophobic” and Islam is being attacked. (These are the Islam hustlers who operate on the same principles that black race hustlers so effectively used to extort concessions over the last six decades or so).

Nobody has done any real work to support this proposition, nor is it clear exactly how it would be tested. My view is that the grammar "Islam is x" is itself problematic because Islam has expressed itself throughout history in a variety of fashions. It is more useful to talk in terms of how seriously engaged with Islam, the Koran and other texts, a Muslim is. What is significant is how Muslims today are using Islam and most of those who are in power either throughout a large territory or within a small community tend toward, if not fully advocate, the very supremacist ideas that we try to tell ourselves are reserved for the few "extremists." Presumably most Germans did not wish to see all Nazi atrocities carried out but in the end they fell in line because they had to. Those our politicians and press call the "extremists" are in one sense more accurately the "good" Muslims who are following their Islamic beliefs dutifully.

FP: Tell us how Western shame and guilt play into all of this.

Siegel: One of the dirty little secrets the Control Factor preys upon is that if we believe we control something we can comfort ourselves that we can change it. Remember the horror film- the threat has one purpose and that is to destroy you. You can not change it, talk it out of it, teach it alternatives or otherwise. That is what makes it so inherently frightening. If we can convince ourselves that we caused the threat to act the way it does we can maintain the secret hope that we can change it. Consequently, there is a tremendous attraction to blaming ourselves for the Islamic Enemy's behavior. And we see this power in our readily accepting responsibility for terror- because of our occupation, our greedy quest for oil, our failure to extend a hand of "engagement," Israel's building settlements, our making videos that defame Mohammed and so on. Again, the relationship is defined by the enemy blaming us for his actions and our accepting such responsibility.

Shelby Steele has written brilliantly about what he calls "white guilt" and outlines how whites during the 60′s and thereafter were pressured into a transaction whereby in order to re-obtain a sense of moral authority they accepted blame for the condition of blacks and behaved as if guilty. Blacks were able to extract great concessions and whites were able to view themselves as morally restored and redeemed. At a certain point, however, the behavior takes on a life of its own and the narratives become deeply embedded in the culture and, as we can see today, difficult to uproot.

Western guilt is an extension of Steele's notion. President Obama's confessionals to the Arab world admitting that America has made "mistakes" and was not born a colonial power express this same tendency to appease through guilt. Hillary Clinton's "reset" with Russia conveyed the same submissive request for a more acceptable response. In being guilty we presume the other party will recognize our contrition and respond in like kind. One of the Control Factor's most devastating moves is employed- presuming the other is just like us and will respond the way we would. This is frequently how an enabler justifies his continuous support for an addict. The problem, however is that our Islamic Enemy is NOT like us and will not respond in like kind. Rather, as we repeatedly refuse to learn, appeasement invites more abuse from an enemy. This becomes the "game of guilt;" it tends to expand to greater and greater consequences. Paradoxically, psychological defenses tend to create the very outcomes they seek to eliminate and it is no different here. It is a game we love to play but, unfortunately, the game gives us no rules for how to end it.

All behavior is instructive. That is, we teach others how to treat us. The game of guilt, along with other Control Factor tools, teaches our Enemy it is winning and to continue playing.

FP: The reason Nidal Hasan was able to perpetrate his murder spree at Fort Hood is precisely because of our Control Factor. Please connect the dots for our readers.

Siegel: Just as I used to look at Hitler when I was young and be amazed that no one could see what he was about, in retrospect the same applies to Hasan. It is precisely all the elements of the Control Factor that could allow this man, a Soldier of Allah, to be positioned as he was. He was blatantly voicing his Islamist views and Jihadi intent including, even, an essay recommending the "painful liquidation" of non-Muslims. Yet, in the Army of all places, the Control Factor operated to allow and even foster his work. Even after the murders, we continue the denial by calling it "workplace violence." He is the Civilization-Violent Jihad combo! And we continue to enable the same infiltration elsewhere.

FP: Tell our readers about "The Project" and "Explanatory Memorandum." These are realities that serve as great threats to the Control Factor, right?

Siegel: These are separate sets of documents that outline the Muslim Brotherhood's goals and plans underlying the Civilization Jihad. The former was discovered in Europe and extends globally. The 1991 Explanatory Memorandum emerged in 2008 from the Holy Land Foundation trial and describes the Brotherhood's work in America as a "Civilization-Jihadist Process with all the word means" and "a kind of grand Jihad in eliminating and destroying the Western civilization from within and 'sabotaging' its miserable house by their own hands and the hands of the believers so that it is eliminated and God's religion is made victorious over all other religions."

Much as the communists of the Soviet Union had formulated in the 1950s a detailed long term plan to destroy America (many of the effects of which we are seeing of late including destroying the nuclear family, secularizing the nation, feminizing men …) these documents identify many strategies to infiltrate while eroding the foundations of our civilization in order to transform it into an Islamic one. The Control Factor has many ingenious ways to convince us that this is ridiculous, that our courts and system would never allow such a thing, that one is racist or "Islamophobic," if not insane, for even thinking this is real. And just as with the communists, time is plentiful. Even more so with our Islamic Enemy, a multi-decade plan is short term. It is not critical that a seriou sly engaged Muslim lives to see the result. It is critical, more correctly a duty, however, that he carries on his Jihad. Patrick Poole and The Center for Security Policy's Team B Report, Shariah: The Threat to America, are excellent sources for your readers to pursue these documents.

FP: And so what you call an "Inner Jihad" has to start. It's our, as you say, mandatory "addiction treatment." Please explain.

Siegel: The "Inner Jihad" is the effort we must undertake to gain control over our Control Factors. There is a famous Hadith in which Mohammad, returning from a successful battle, essentially says that the physical fight was the "lesser Jihad" and it is time to then attend to the "greater Jihad �"- that internal battle against our own internal appetites, lusts, wrong thinking and so forth. While that Hadith has been falsely utilized to say that "Jihad" is not violent, it is useful to us as a symbol of the vicious effort we must take internally against our own Control Factor tendencies.

As I said earlier, the Control Factor is "active" and "continuous" so we must constantly monitor and combat it. Like "Whack-a-Mole," just as we may think we have addressed it, another variation pops right up. I use the terms "addict" and "enabler" because we truly need a form of rehab to break the habitual power of the Control Factor and because our relationship with our Islamic Enemy is very much like that between a typical addict and his enabler. And just as it is so difficult for an addict to kick his habit, so does the enabler act essentially addicted to his behavior and find it so difficult to change. At its core, the relati onship involves the transfer of responsibility for our Islamic Enemy's hate and resultant actions onto us with our response framed essentially as an effort to do what we can to try to address the Enemy's grievance. (Your book, United in Hate, describes this addiction to hate in detail.

The key to the Inner Jihad is to learn to transfer responsibility for our Islamic Enemy's hate and resultant actions back to it and take responsibility back for our own situation. We must learn all we can about the enemy. We must unwind our inappropriate projections and introjections and rediscover who we are and are not. We must speak up. We must support those Muslims who promote expressions of Islam that are consistent with our principles. And we must stalk the C ontrol Factor, constantly be on guard for its intrusion. This is an individual endeavor as each of our Control Factors uses its own methods. The book gives plenty of examples of each maneuver discussed but it is important for each of us to discover the unique workings of his own mind. That takes the work of the Inner Jihad.

FP: Share with our readers what you mean by the "Turnaround Moment."

Siegel: There is a moment in typical horror films where the central characters have been pushed to their limit. They then change and fully embrace the willingness to be as ruthless as the threat they face. No more moral high ground; no more futile attempts to ignore or change the threat's essence. As Lee Harris described in The Suicide of Reason, it is the willingness o r license to be (not necessarily actually being) as ruthless that is critical. It is a mental state that sheds all the prior counter-productive efforts at denial to finally clearly focus on the threat faced. Part of the Inner Jihad is to reach that Turnaround Moment sooner rather than later.

FP: You suggest that "mirroring" should be used as part of our arsenal. Tell us about it.

Siegel: Mirroring is a literal approach to transferring back to the addict responsibility that we have been inappropriately accepting. Critical to the addict/enabler relationship is asymmetry. Like the addict, the enemy uses a less limiting set of rules than we do. The enemy typically initiates aggression while we respond only. Mirroring means that we demonstrate our willingness to act symmetrically, to be governed by the same rules. It is stunning how much is accomplished when one's attitude simply is clear that he will do what is necessary; often not much else is needed as the addict or enemy realizes the game is fundamentally changed. But other times action is absolutely needed. Demonstrating that we are not afraid to treat the enemy as it treats us carries great meaning. Imagine (international law aside) if Israel announced that from now on it will mirror Hamas such that if civilian populations are targeted by bombs from Gaza, Israel will do the same (it is accused of such anyway). The population might finally rethink and take responsibility for its privilege of voting its leaders. As stated earlier, all behavior is instructive and when we mirror we teach the other the effects of his behavior.

Conversely, some situations demand that we assert asymmetry; those cases where it is necessary to highlight our differences with the enemy. Just this week, an disingenuous report was issued by an NGO drawing an equivalence between Palestinian and Israeli schoolbooks claiming that both sides have their relativistic "narratives." Yet, as the Palestinian Media Watch's website has demonstrated for years, there is nothing in the West anywhere comparable to the hatred spewed daily by the Palestinian Authority, including through its education system. It is interesting to note that while the US State Department initially funded the "study,"- in what appears to be an attempt to sanitize the PA's record so that the US can continue to fund the PA against the spirit of US law- Hillary Clinton has a difficult time escaping her conclusion as Senator in 2007 that these schoolbooks along with other media "profoundly poison(s) the minds of these children." It is most important that we do not succumb to this type of use of symmetry that distorts the profound differences between us and the enemy.

Essentially, we are not clear as a nation, participating in a world with international rules, how to best fight this enemy. The first act of any rehab is to acknowledge that we do not know how nor are we yet competent to stop our addictions. This is not a book about policy. In fact, the "right" policies are unlikely to emerge until a critical mass has meaningfully dealt with their Control Factors and share a common perspective. We like to look at our history and assume a single perspective throughout but the truth is that we had to learn how to respond to Pearl Harbor, the Nazis, the Cold War etc. The same applies here. Our press promotes "elites" who are tasked with acting as if they possess the "true wisdom" to deal with our threats but the truth is we do not know nor are we equipped to marshal enough of our population to agree just yet. The sooner we learn, however, the less we will suffer. Mirroring has always been a key component of those lessons.

I have been encouraged by some recent acts that have begun to nip at the asymmetry. For years, the language of "feelings" had been reserved for our enemy while we were limited to that of "action;" we would do terrible acts that would cause bad feelings in the enemy which would then serve to justify whatever response it made. It had always been a question of the harsh insensitive acts Westerners do against Muslims and the resulting hurt, loss, shame etc. that Muslims experience. The Ground Zero Mosque incident, however, broke new ground because all of a sudden non-Muslims' feelings became the focus and were cast as resulting from Muslim acts. Another example was seen in how quickly the attempt to blame the Benghazi murders on the video about Mohammad fell apart. Just as large corporations eventually learned to turn away from shakedown attempts from race baiters, we are beginning to learn to demand symmetry through mirroring. A word of caution: When enablers change their behavior and demand symmetrical rules for the addict, the latter typically initially erupts with great resistance. This is a stage we must be prepared to tolerate and fully withstand as it creates the only real chance for the addict to finally change. It is critical, therefore, that when we finally engage in mirroring that we be prepared to see it through completion.

FP: What if we fail to engage in our own Inner Jihad and the Control Factor stays firmly in place?

Siegel: Critical to the Inner Jihad is the realization that our civilization is fragile; not to be taken for granted. Our demands for multi-culturalism and diversity have bumped heads with the simple paradox that tolerating the intolerant leads to extinction. Tolerating the intolerant is perhaps the most crystalline version of asymmetry we have accepted. Seriously engaged Muslims MUST place the Koran above all law while in America, the Constitution ranks supreme. As Omar Ahmad , founder of CAIR, reputedly said, “Islam isn’t in America to be equal to any other faith, but to become dominant. The Koran is the highest authority in America and Islam is the only accepted religion on Earth.” Who makes law- the people or Allah? While the Control Factor constantly seeks for some accommodation between the two, this conflict CAN NOT be negotiated. Only one can survive not because we have declared “war” but because our Islamic Enemy has. That is, perhaps, the lesson we will most need to fully learn, one way or another. We will eventually hit a Turnaround Moment as a nation and if enough of us are not truly prepared to fight and continue to be controlled by our delusions, we will lose. If we truly seek to win, it is better to get there sooner while we have advantages than later.

FP: Bill Siegel, thank you for joining FrontPage Interview.

And thank you for writing this superb and most important book.

We encourage all of our readers to get their hands on The Control Factor: Our Struggle to See the True Threat and to read it!

Editor’s note: To watch *The Glazov Gang*‘s recent discussion about the Muslim Brotherhood’s infiltration of the United States and the Obama administration, see this week’s episode below:

Freedom Center pamphlets now available on Kindle: Click here.

Filed Under: Daily Mailer, FrontPage Tagged With: Denial, Islam, muslim brotherhood, Obama, Siegel, The Control Factor

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About Jamie Glazov

Jamie Glazov is Frontpage Magazine's editor. He holds a Ph.D. in History with a specialty in Russian, U.S. and Canadian foreign policy. He is the author of the critically acclaimed and best-selling, ***United in Hate: The Left’s Romance with Tyranny and Terror.*** His new book is ***High No on For America.*** He is the host of Frontpage’s television show, ***The Glazov Gang,*** and he can be reached at jamieglazov11@gmail.com. Visit his sit at ***JamieGlazov.com***.

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AdinaK 86p · *11 hours ago*

The war being waged has two components - mental and physical. The mental side is a minefield of constructs, deeply implanted within generations of Americans, and its PC chickens are coming home to roost. So much so, millions of Americans (westerners) cannot break free of its shackles. But it is not as if these mental chains magically appeared. Far from it - http://adinakutnicki.com/2012/11/26/the-death-of-...

In addition, the fault-lines of democracy allowed for the most retrograde forces, on this planet, to infiltrate and penetrate the body politic- http://adinakutnicki.com/2012/09/02/the-subversio...

IF the mental and physical constraints are not immediately removed, it is a given that western civilization will fall. Cause and effect.
Adina Kutnicki, Israel - http://adinakutnicki.com/about/

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1 reply · *active 30 minutes ago*

0

dmw · *30 minutes ago*

And I would think one "phy sical constraint" is to not let them in in the first place. By & quot;them" I mean those who have allegiance to a socio-political system disguised as a religion that seeks world dominance by man imposed methodology/effort -- unlike Judaism and Christianity properly understood. If we are to "believe", the world already has a King and does not need a Caliph.

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0

MikeWood · *6 hours ago*

Ground-breaking, brilliant. There are absolutely essentially lessons to be learned from this. Buy this book, read it, study it, and lend it to your friends and colleagues. Do it.

Report

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0

lambsev77 54p · *4 hours ago*

The fall of Rome... The fall of the 3rd Reich... The fall of Western Civilization...

oooooh... Scary!

How about the fall of humankind recorded in Genesis Chapter 3 and following?

We're ALL GONNA DIE! But will you rise with Christ?

Report

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+1

@WolfyJam · *2 hours ago*

Notice how celebrities basking in their narcissism think they can dictate culture to us while they live their lives in the comfort of their ivory castles. Mia farrow has no clue what the right to bear arms means and because of that she needs to shut the hell up. _As far as blacks go-- I grew up in the 70's coming home from Hallahan H.S. in Philadel phia, me and my small group of girls were swarmed by a mob of black girls who would kick and slap and pull hair without provocation. of course we would fight back but then that was back in the day when whites weren't sissies. Still I made excuses for them. Black men would get in my face for no other reason than to intimidate me. rocks were thrown a my car for no reason. So, in short, based on my experiences Blacks are the cause of racism and if they hate whites so much then they should stay away completely and totally. _

Report

Reply

+1

@WolfyJam · *2 hours ago*

I read the Control factor and it was excellent. I wish more people would realize that our country is at its most vulnerable than ever in its history. the jihadis have basically taken over the inner cities. Islam's love for violence coupled with ignorance and narcissim are a recipe for disaster. I hope Americans wake up in time to save their future. I'm not optimistic though. I think its over but still I fight on.

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From: Bill Siegel [redacted]
Sent: 2/8/2013 9:02:08 PM
To: jeevacation@gmail.com
Subject: Re: Fro- The Control Factor - Frontpage Magazine interview
Attachments: image001.gif; image002.jpg; image003.png; image004.png; image005.jpg; image006.jpg; image007.png

Importance: High

Stillllllllllllll just engaged. I meant shirley

From: Jeffrey Epstein <jeevacation@gmail.com>
To: Bill Siegel
Sent: Fri Feb 08 15:49:51 2013
Subject: Re: Fro- The Control Factor - Frontpage Magazine interview

shirley or your wife

On Fri, Feb 8, 2013 at 4:48 PM, Bill Siegel <[redacted]> wrote:

> I will let you know when I go back. Do you know her?
>
> ---
>
> **From:** Jeffrey Epstein <jeevacation@gmail.com>[redacted]
> **To:** Bill Siegel
> **Sent:** Fri Feb 08 15:16:44 2013
> **Subject:** Re: Fro- The Control Factor - Frontpage Magazine interview
>
> great. place.. when will you go.. did you get married? i m between alber and santa fe,, zorrro ranch, you can google earth it.
>
> On Fri, Feb 8, 2013 at 4:10 PM, Bill Siegel <[redacted]> wrote:
>
>> You ok? I became friendly with shirley maclaine last year and went to her ranch in sante fe. I may go back and remembered you own half the ranch land there or something. Do you still like it there?
>>
>> ---
>>
>> **From:** Jeffrey Epstein <jeevacation@gmail.com>
>> **To:** Bill Siegel
>> **Sent:** Fri Feb 08 14:58:01 2013
>> **Subject:** Re: Fro- The Control Factor - Frontpage Magazine interview
>>
>> I already rad it. congragulations hope to see you soon
>>
>> On Fri, Feb 8, 2013 at 3:40 PM, Bill Siegel <[redacted]> wrote:
>>
>>> Bill Siegel hopes this might be of interest to you: http://frontpagemag.com/2013/jamie-glazov/the-control-factor-our-struggle-to-see-the-true-threat/
>>>
>>> # The Control Factor: Our Struggle to See the True Threat
>>>
>>> February 8, 2013 By Jamie Glazov Comments (6)

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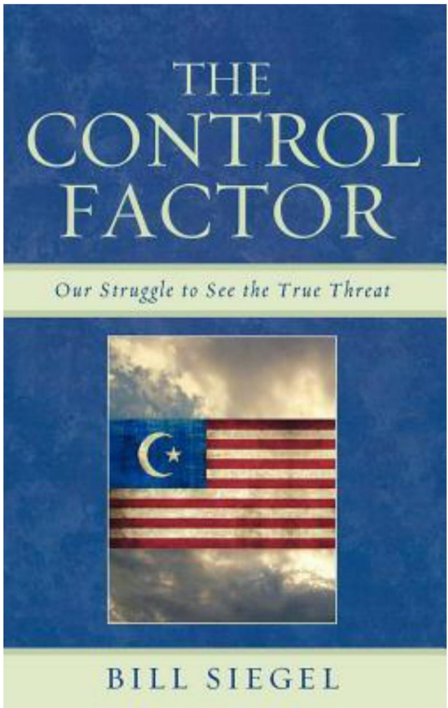

FrontPage Interview's guest today is Bill Siegel, a lawyer and business executive. He has been a producer of several documentary films and assists numerous non-profit organizations. He is the author of The Control Factor: Our Struggle to See the True Threat.

FP: Bill Siegel, welcome to FrontPage Interview.

Congratulations on this brilliant book. It is without question one of the most vital works of our time.

Let's begin with what inspired you to write it.

Siegel: Thanks for having me Jamie. As a young boy born in the mid 1950s, I was fascinated with footage of Hitler and the Third Reich and could never understand how the Jews of the time could not see the evil that seemed so obvious. Not yet appreciative of the benefit of hindsight, I could not comprehend the blindness. Following 9/11, like so many others, I began to study Islam, its history, its current movements, terrorism and so on. As I would learn one stunning aspect after another, I would discuss them with friends and associates. Rather than confront the facts I would present, they would find one clever way after another to avoid the frightening truth of what America and the West truly face. Their fear appeared obvious to me. I began to catalog many of my friends' different maneuvers to dispel the anxiety that they found so difficult to endure. The more I focused on their mental processes (as well as my own) the more I began to see a structure to the mental endeavor and to understand what I had, as a child, found so difficult to explain.

FP: Tell us about the Control Factor, what you describe as "that effort our minds enga ge in in order to keep us blind" and that "process of a voiding seeing the threats we face." It's also about, as you state, trying to believe that the threat is under our control, when in fact it is not. Kindly enlighten us as to these profound insights you make in terms of the Control Factor.

Siegel: First, let's distinguish the "real world" where real battles are taking place from the mental battlefield which occurs in each of our minds. We tend to believe our perceptions are simply clear realizations of what is "out there" and overlook how much our internal worlds can literally determine what we see. When our internal minds become anxious and sense a loss of "control," they tend to concoct ways to distort our perceptions so as to restore that sense of inner control. I describe the Control Factor as an "active and continuous process" designed to maintain that sense, if not illusion, of control. We naturally think that our thinking and feeling processes are passive; that they just happen. Yet when faced with truly frightening prospects, the mind is geared to actively distort.

Similarly, the sense of control must be continuously maintained so the Control Factor operates constantly. In turn, the sum of this active and continuous undertaking makes these perceptions all the more familiar and thus seemingly all the more "real." In one sense, the Control Factor is the mechanism of what Andy McCarthy entitled one of his numerous excellent books- willful blindness. The Control Factor is cleverer than we are aware; that is almost tautological as, if our minds are to create ways to keep us in denial, they must out maneuver our conscious thinking.

Since World War II, America has had limited experience with threats coming to the homeland. Most of America's history has been about "over there," where we have always known that if things got too out of hand (e.g. Vietnam) we could always return home. The current generations, for a wide array of reasons, have had virtually no experience with a threat to this land. (The documentary, Generation Zero, is interesting on this point).

Consequently, the process of waking up to such a threat parallels the arc of a typical horror film. In such a film, there is typically a cast of characters surrounding one or two main characters. We in the audience know there is a threat coming – be it a monster, a virus, a psycho killer, an alien, the blob that ate Cincinnati etc. This threat is typically defined by its intent- the singular goal of destroying the characters. Much of the initial exposition shows how the characters first are oblivious to the destruction the threat brings about, then explain it in familiar terms only to finally open their eyes to see that something uniquely terrifying is happening. The next stage usually involves a series of failed attempts to deal with the threat- from trying to negotiate with it, to appease it, to coax it, to threaten it with ineffective weapons and so forth. Most of these failings are due to not adequately appreciating the threat for what it truly is and projecting onto it a host of other attributes instead. The final stage generally involves a back-up-against-the-wall decision by whichever characters remain alive. I named this the "turnaround moment" when the character becomes willing to be as ruthless as the threat. That change in mental state is necessary to ensure survival. Ultimately, the storyline is a race for whichever characters remain to wake up fully and use whatever advantages they may still have to beat the threat.

This is the same arc our minds go through in battling our own Control Factors, our own compulsions to deny that which is staring us in the face. Ultimately, the question is whether we will be able to wake up while we still have advantages and give ourselves permission to fully fight the battle we are in.

I said earlier that there is a structure to the Control Factor. To oversimplify, I view it much as a pyramid where on the bottom are the many minute by minute thoughts that are manipulated. I call this level of maneuvers the many "D's" as they include the psychological defenses such as distortion, denial, demonization, deflection, deletion, detachment, delusion, displacement, discolorization and so forth. Layered upon these are moves such as projection, where we can assign to our Islamic Enemy traits we wish to see in them or introject traits from them into ourselves that we wish not to acknowledge. These maneuvers involve a mixing of identities where we actually lose clarity about who we are and who the enemy is. Projection and introjection are active almost across the board. It is always helpful, for instance, to ask how what the enemy accuses us of is more appropriately descriptive of it. When we add Western Guilt and Shame, our need to be liked, and other psychological dimensions, basic thoughts solidify into larger fantasies.

As these narratives ("Our courts will never allow that," "As a superpower we will always be able to win any fight we put our minds to," "Assimilation will ensure Muslims are westernized" …) gain consent from others they tend to guide us deeply and become infused on our policies. Ultimately, what emerges is a relationship we take with our Islamic Enemy that parallels that between an addict and an enabler. Emblematic of this relationship is the "transfer of responsibility" in which we assume responsibility for the enemy's behavior who is addicted to transferring it away from itself. The Control Factor actively maintains this relationship and makes changing that relationship as difficult a chore as any addict finds in breaking his addiction. And just as an addict needs to devote serious effort and consciousness to his addiction, so must we devote great energy to understanding how the Control Factor ultimately sabotages us.

FP: Describe the threat we face in our Islamic enemy. And you talk about the three levels of jihad against us. What are they?

Siegel: Simply stated, our Islamic Enemy seeks the totalitarian domination of Islam throughout the world – Islamic supremacy. It seeks to have the West submit to Islam. Obviously, this does not mean that everybody becomes a Muslim. Islam, in all its varied expressions, permits dhimmis- those Christians, Jews, and some others who are permitted to remain as protected non-Muslims as long as they submit to an inferior status. What is critical is that Shariah (Islamic Law) ultimately rules the world.

Jihad, loosely, is the effort/struggle to see this vision through. The most obvious method of Jihad is through violence; it is the one most familiar to most Westerners and almost all of the Koranic references to Jihad are based in violence. The Violent Jihad includes al-Qaeda and its offshoots as well as other groups that formed around the globe independent of al-Qaeda. It also obviously includes the violence from Islamic nations such as the Islamic Republic of Iran whose constitution specifies such vision. It also includes, however, various militant groups and training camps here in the US as well as ad hoc efforts of individuals.

Since 9/11, there have been something in excess of 15,000 Violent Jihadic attacks across the globe. However, as terrible as this is, we have a tendency in the West to think that the only dimension of threat we face comes from violence. While the Bush administration helped initiate this thinking, the Obama administration has actively abused it by limiting any discussion of the threat we face to al-Qaeda and some other terrorist groups abroad. As frightening as these groups are, we can get some ease from thinking they are a band of "extremists limited in number, weaponry, sophistication, and means. Stunningly, Hillary Clinton recently estimated that there are only about 50,000 "homicidal" violent extremists around the world who simply have been able to project power much greater than their number should allow. Here the Control Factor makes the threat appear more easily manageable.

Jihad, however, is pursued in other often even more effective ways which I have grouped into three "levels." A second more insidious level of threat is what the Muslim Brotherhood itself called the "Civilization Jihad." It is the effort to infiltrate all aspects of our society, peacefully according to our laws, in order to later be in position to sabotage and destroy it from the inside. The Civilization Jihadists have learned the culture and rules of the territories they seek to command and use those rules to maneuver—specifically using our freedoms to destroy our freedoms. They use "lawfare" to seek changes in our laws so as to push Shariah into our society. Your readers should read Daniel Pipes and Brooke Goldstein's Lawfare Project material and others to fully appreciate how cancerous this activity has become. This includes intimidating in a variety of ways anyone who speaks out against them or Islam and seeking to squelch our treasured broad right to free speech so as to ultimately prevent any criticisms of Islam. Once criticism of Islam is prohibited, little can stop it from cascading throughout the culture.

The Civilization Jihad includes situating such Jihadists in critical positions in the society, in the government, in the legal system, the military, and elsewhere. It includes the control over university programs that distribute propaganda about Islam and Islamic history which then filters down throughout textbooks for even younger students. It includes control over most of the nation's mosques and local Imams guiding the messages engaged Muslims are receiving. Most troublesome are the Muslim groups (CAIR, ISNA, MSA and others associated and/or joint venture partners with the Muslim Brotherhood) supposedly interested in "outreach" which know how to appear Westernized and interested in the goals of Western Civilization. They have fooled a large part of our authorities and media due in part to their patience and willingness to chip away, one airport prayer room, one frivolous intimidating lawsuit, one Congressman or CIA officer, one mosque, one ruling at a time.

Particularly in the US, given our deep attachment to freedom as well as cultural and psychological tendencies toward diversity, Western guilt and expectations of truthfulness, this effort is devious and difficult to uproot. The Civilization Jihadists present one face to the American public which is completely at odds with their true agenda and how they deal in private. Jamie, you and David and others such as Steve Emerson, Frank

Gaffney, Andy McCarthy and others have done so much to uncover this level of Jihad that your readers should be urged to review as much of their work (including Steve's recent excellent documentary, The Grand Deception, and Frank's important web video course, The Muslim Brotherhood in America) as possible.

Finally, there is a third level – the International Institutional Jihad. Here the most powerful international institutions such as the UN and the Organization of Islamic Cooperation and others seek to push into America from without those changes which are difficult to complete from within. The OIC is the largest Islamic institution in the world. It essentially controls the vote in the UN's General Assembly and thus explains in part the absurd and abject pro-Islamic, anti-Israel thrust of that organization. This level seeks to use the power of Islamic nations to work from outside the West to force changes within the West. While there are various conflicts between many of the nations, being Islamic majority states, there is a great deal they agree upon which becomes the focus of these efforts. Just as the Obama administration is beginning to cooperate with international efforts to control gun ownership, so has Hillary Clinton's Istanbul Process become a dangerous step in the effort to restrict speech critical of Islam by norm (or possibly even treaty) when it may not be fully executable by domestic action alone.

I should point out that Stephen Coughlin, the former Pentagon officer who has an important must-see presentation of Islamic Law, uses different names for these same three levels – Jihad, Dawa, and Ummah. Had I seen his work before I wrote my book I would have conformed to his categorizations.

We must learn how powerful language has become on all three levels. Words such as "peace,� $B!I "freedom," "terrorism," and phrases such as "human rights" have different meanings for us and for our Islamic Enemy. To oversimplify, "peace" is not something for now but that which comes when all the earth is submitting to Islam. In the context of battles, "peace" is at best a temporary ceasefire. "Freedom" is best understood as having the freedom to fully submit to Islam, not to choose whatever beliefs one desires while respecting the same right in others. We've all seen how "human rights" and "terror" really only apply among Muslims, not to non-Muslims. Our enemy fully understands these differences and uses them at all levels to paralyze us.

Look simply at how the phrase "Israeli-Palestinian conflict" has equalized the two parties, making it all the easier to ascribe features of one to the other and view the problem as a simple-to fix division of assets into statehoods but for personality problems among the leaders. The simple truth is that this is and has always been a one-sided Arab war against Israel as Ruth Wisse and others have described and, as Bibi Netanyahu made clear, the ONLY state truly at issue here has been the State of Israel that the Arabs have refused for over half a century. Nonetheless, the Control Factor hypnotically abuses the mind's susceptibility to the intricacies of language.

Even the label "Peace Process" has been damaging language. While most focus upon the first word, turning this into a "process" has helped ensure that peace is never obtained. It is more appropriately called the "Extortion Process" because all that results is that violence is used over decades to extract concessions from Israel.

These three levels must be understood for their differences while united by a single goal. While these levels often operate together and assist each other, we must avoid "level confusion" which the Control Factor employs to curtail our fears. If the Obama narrative is swallowed- that the only threat is the Violent Jihad- we will miss the other contamination fomenting within our borders. We must appreciate how these levels work together and even unite with other forces such as the global Leftist movement that you, Jamie, have described so forcefully in United in Hate.

FP: You write about how we like to talk of "Good Muslims" and how we are always on the eternal search for "moderate" Muslims (Khatami, Mousavi, Abbas, etc), while we stress how the "extremists" are the real problem and how "few" they really are. All of this is connected to the Control Factor. Enlighten us.

Siegel: The Control Factor seeks to have us feel in control of the situation. The easiest way to do this is to simply minimize the number of potential enemies. We have been lectured for years about how Islam is a "religion of peace" and that the violence we see (remember that we have already improperly limited the problem to violence) is the product of a small number of "crazies" (remember Hillary Clinton's 50,000) who have distorted Islam. I call this the “Peaceful Muslim Disclaimer” as virtually everyone in the press and government has been bullied into making some statement of the kind to silence those who will pressure them that they are “Islamophobic” and Islam is being attacked. (These are the Islam hustlers who operate on the same principles that black race hustlers so effectively used to extort concessions over the last six decades or so).

Nobody has done any real work to support this proposition, nor is it clear exactly how it would be tested. My view is that the grammar “Islam is x” is itself problematic because Islam has expressed itself throughout history in a variety of fashions. It is more useful to talk in terms of how seriously engaged with Islam, the Koran and other texts, a Muslim is. What is significant is how Muslims today are using Islam and most of those who are in power either throughout a large territory or within a small community tend toward, if not fully advocate, the very supremacist ideas that we try to tell ourselves are reserved for the few ”extremists.” Presumably most Germans did not wish to see all Nazi atrocities carried out but in the end they fell in line because they had to. Those our politicians and press call the “extremists” are in one sense more accurately the “good” Muslims who are following their Islamic beliefs dutifully.

FP: Tell us how Western shame and guilt play into all of this.

Siegel: One of the dirty little secrets the Control Factor preys upon is that if we believe we control something we can comfort ourselves that we can change it. Remember the horror film- the threat has one purpose and that is to destroy you. You can not change it, talk it out of it, teach it alternatives or otherwise. That is what makes it so inherently frightening. If we can convince ourselves that we caused the threat to act the way it does we can maintain the secret hope that we can change it. Consequently, there is a tremendous attraction to blaming ourselves for the Islamic Enemy’s behavior. And we see this power in our readily accepting responsibility for terror- because of our occupation, our greedy quest for oil, our failure to extend a hand of “engagement,” Israel’s building settlements, our making videos that defame Mohammed and so on. Again, the relationship is defined by the enemy blaming us for his actions and our accepting such responsibility.

Shelby Steele has written brilliantly about what he calls “white guilt” and outlines how whites during the 60′s and thereafter were pressured into a transaction whereby in order to re-obtain a sense of moral authority they accepted blame for the condition of blacks and behaved as if guilty. Blacks were able to extract great concessions and whites were able to view themselves as morally restored and redeemed. At a certain point, however, the behavior takes on a life of its own and the narratives become deeply embedded in the culture and, as we can see today, difficult to uproot.

Western guilt is an extension of Steele’s notion. President Obama’s confessionals to the Arab world admitting that America has made “mistakes” and was not born a colonial power express this same tendency to appease through guilt. Hillary Clinton’s “reset” with Russia conveyed the same submissive request for a more acceptable response. In being guilty we presume the other party will recognize our contrition and respond in like kind. One of the Control Factor’s most devastating moves is employed- presuming the other is just like us and will respond the way we would. This is frequently how an enabler justifies his continuous support for an addict. The problem, however is that our Islamic Enemy is NOT like us and will not respond in like kind. Rather, as we repeatedly refuse to learn, appeasement invites more abuse from an enemy. This becomes the ”game of guilt;” it tends to expand to greater and greater consequences. Paradoxically, psychological defenses tend to create the very outcomes they seek to eliminate and it is no different here. It is a game we love to play but, unfortunately, the game gives us no rules for how to end it.

All behavior is instructive. That is, we teach others how to treat us. The game of guilt, along with other Control Factor tools, teaches our Enemy it is winning and to continue playing.

FP: The reason Nidal Hasan was able to perpetrate his murder spree at Fort Hood is precisely because of our Control Factor. Please connect the dots for our readers.

Siegel: Just as I used to look at Hitler when I was young and be amazed that no one could see what he was about, in retrospect the same applies to Hasan. It is precisely all the elements of the Control Factor that could allow this man, a Soldier of Allah, to be positioned as he was. He was blatantly voicing his Islamist views and Jihadi intent including, even, an essay recommending the “painful liquidation” of non-Muslims. Yet, in the Army of all places, the Control Factor operated to allow and even foster his work. Even after the murders, we continue the denial by calling it "workplace violence." He is the Civilization-Violent Jihad combo! And we continue to enable the same infiltration elsewhere.

FP: Tell our readers about "The Project" and "Explanatory Memorandum." These are realities that serve as great threats to the Control Factor, right?

Siegel: These are separate sets of documents that outline the Muslim Brotherhood's goals and plans underlying the Civilization Jihad. The former was discovered in Europe and extends globally. The 1991 Explanatory Memorandum emerged in 2008 from the Holy Land Foundation trial and describes the Brotherhood's work in America as a "Civilization-Jihadist Process with all the word means" and "a kind of grand Jihad in eliminating and destroying the Western civilization from within and 'sabotaging' its miserable house by their own hands and the hands of the believers so that it is eliminated and God's religion is made victorious over all other religions."

Much as the communists of the Soviet Union had formulated in the 1950s a detailed long term plan to destroy America (many of the effects of which we are seeing of late including destroying the nuclear family, secularizing the nation, feminizing men …) these documents identify many strategies to infiltrate while eroding the foundations of our civilization in order to transform it into an Islamic one. The Control Factor has many ingenious ways to convince us that this is ridiculous, that our courts and system would never allow such a thing, that one is racist or "Islamophobic," if not insane, for even thinking this is real. And just as with the communists, time is plentiful. Even more so with our Islamic Enemy, a multi-decade plan is short term. It is not critical that a seriously engaged Muslim lives to see the result. It is critical, more correctly a duty, however, that he carries on his Jihad. Patrick Poole and The Center for Security Policy's Team B Report, Shariah: The Threat to America, are excellent sources for your readers to pursue these documents.

FP: And so what you call an "Inner Jihad" has to start. It's our, as you say, mandatory "addiction treatment." Please explain.

Siegel: The "Inner Jihad" is the effort we must undertake to gain control over our Control Factors. There is a famous Hadith in which Mohammad, returning from a successful battle, essentially says that the physical fight was the "lesser Jihad" and it is time to then attend to the "greater Jihad �"- that internal battle against our own internal appetites, lusts, wrong thinking and so forth. While that Hadith has been falsely utilized to say that "Jihad" is not violent, it is useful to us as a symbol of the vicious effort we must take internally against our own Control Factor tendencies.

As I said earlier, the Control Factor is "active" and "continuous" so we must constantly monitor and combat it. Like "Whack-a-Mole," just as we may think we have addressed it, another variation pops right up. I use the terms "addict" and "enabler" because we truly need a form of rehab to break the habitual power of the Control Factor and because our relationship with our Islamic Enemy is very much like that between a typical addict and his enabler. And just as it is so difficult for an addict to kick his habit, so does the enabler act essentially addicted to his behavior and find it so difficult to change. At its core, the relationship involves the transfer of responsibility for our Islamic Enemy's hate and resultant actions onto us with our response framed essentially as an effort to do what we can to try to address the Enemy's grievance. (Your book, United in Hate, describes this addiction to hate in detail.

The key to the Inner Jihad is to learn to transfer responsibility for our Islamic Enemy's hate and resultant actions back to it and take responsibility back for our own situation. We must learn all we can about the enemy. We must unwind our inappropriate projections and introjections and rediscover who we are and are not. We must speak up. We must support those Muslims who promote expressions of Islam that are consistent with our principles. And we must stalk the Control Factor, constantly be on guard for its intrusion. This is an individual endeavor as each of our Control Factors uses its own methods. The book gives plenty of examples of each maneuver discussed but it is important for each of us to discover the unique workings of his own mind. That takes the work of the Inner Jihad.

FP: Share with our readers what you mean by the "Turnaround Moment."

Siegel: There is a moment in typical horror films where the central characters have been pushed to their limit. They then change and fully embrace the willingness to be as ruthless as the threat they face. No more moral high ground; no more futile attempts to ignore or change the threat's essence. As Lee Harris described in The Suicide of Reason, it is the willingness or license to be (not necessarily actually being) as ruthless that is critical. It is a mental state that sheds all the prior counter-productive efforts at denial to finally clearly focus on the threat faced. Part of the Inner Jihad is to reach that Turnaround Moment sooner rather than later.

FP: You suggest that "mirroring" should be used as part of our arsenal. Tell us about it.

Siegel: Mirroring is a literal approach to transferring back to the addict responsibility that we have been inappropriately accepting. Critical to the addict/enabler relationship is asymmetry. Like the addict, the enemy uses a less limiting set of rules than we do. The enemy typically initiates aggression while we respond only. Mirroring means that we demonstrate our willingness to act symmetrically, to be governed by the same rules. It is stunning how much is accomplished when one's attitude simply is clear that he will do what is necessary; often not much else is needed as the addict or enemy realizes the game is fundamentally changed. But other times action is absolutely needed. Demonstrating that we are not afraid to treat the enemy as it treats us carries great meaning. Imagine (international law aside) if Israel announced that from now on it will mirror Hamas such that if civilian populations are targeted by bombs from Gaza, Israel will do the same (it is accused of such anyway). The population might finally rethink and take responsibility for its privilege of voting its leaders. As stated earlier, all behavior is instructive and when we mirror we teach the other the effects of his behavior.

Conversely, some situations demand that we assert asymmetry; those cases where it is necessary to highlight our differences with the enemy. Just this week, an disingenuous report was issued by an NGO drawing an equivalence between Palestinian and Israeli schoolbooks claiming that both sides have their relativistic "narratives." Yet, as the Palestinian Media Watch's website has demonstrated for years, there is nothing in the West anywhere comparable to the hatred spewed daily by the Palestinian Authority, including through its education system. It is interesting to note that while the US State Department initially funded the "study,"- in what appears to be an attempt to sanitize the PA's record so that the US can continue to fund the PA against the spirit of US law- Hillary Clinton has a difficult time escaping her conclusion as Senator in 2007 that these schoolbooks along with other media "profoundly poison(s) the minds of these children." It is most important that we do not succumb to this type of use of symmetry that distorts the profound differences between us and the enemy.

Essentially, we are not clear as a nation, participating in a world with international rules, how to best fight this enemy. The first act of any rehab is to acknowledge that we do not know how nor are we yet competent to stop our addictions. This is not a book about policy. In fact, the "right" policies are unlikely to emerge until a critical mass has meaningfully dealt with their Control Factors and share a common perspective. We like to look at our history and assume a single perspective throughout but the truth is that we had to learn how to respond to Pearl Harbor, the Nazis, the Cold War etc. The same applies here. Our press promotes "elites" who are tasked with acting as if they possess the "true wisdom" to deal with our threats but the truth is we do not know nor are we equipped to marshal enough of our population to agree just yet. The sooner we learn, however, the less we will suffer. Mirroring has always been a key component of those lessons.

I have been encouraged by some recent acts that have begun to nip at the asymmetry. For years, the language of "feelings" had been reserved for our enemy while we were limited to that of "action;" we would do terrible acts that would cause bad feelings in the enemy which would then serve to justify whatever response it made. It had always been a question of the harsh insensitive acts Westerners do against Muslims and the resulting hurt, loss, shame etc. that Muslims experience. The Ground Zero Mosque incident, however, broke new ground because all of a sudden non-Muslims' feelings became the focus and were cast as resulting from Muslim acts. Another example was seen in how quickly the attempt to blame the Benghazi murders on the video about Mohammad fell apart. Just as large corporations eventually learned to turn away from shakedown attempts from race baiters, we are beginning to learn to demand symmetry through mirroring. A word of caution: When enablers change their behavior and demand symmetrical rules for the addict, the latter typically initially erupts with great resistance. This is a stage we must be prepared to tolerate and fully withstand as it creates the only real chance for the addict to finally change. It is critical, therefore, that when we finally engage in mirroring that we be prepared to see it through completion.

FP: What if we fail to engage in our own Inner Jihad and the Control Factor stays firmly in place?

Siegel: Critical to the Inner Jihad is the realization that our civilization is fragile; not to be taken for granted. Our demands for multi-culturalism and diversity have bumped heads with the simple paradox that tolerating the intolerant leads to extinction. Tolerating the intolerant is perhaps the most crystalline version of asymmetry we have accepted. Seriously engaged Muslims MUST place the Koran above all law while in America, the Constitution ranks supreme. As Omar Ahmad , founder of CAIR, reputedly said, "Islam isn't in America to be equal to any other faith, but to become dominant. The Koran is the highest authority in America and Islam is the only accepted religion on Earth." Who makes law- the people or Allah? While the Control Factor constantly seeks for some accommodation between the two, this conflict CAN NOT be negotiated. Only one can survive not because we have declared "war" but because our Islamic Enemy has. That is, perhaps, the lesson we will most need to fully learn, one way or another. We will eventually hit a Turnaround Moment as a nation and if enough of us are not truly prepared to fight and continue to be controlled by our delusions, we will lose. If we truly seek to win, it is better to get there sooner while we have advantages than later.

FP: Bill Siegel, thank you for joining FrontPage Interview.

And thank you for writing this superb and most important book.

We encourage all of our readers to get their hands on The Control Factor: Our Struggle to See the True Threat and to read it!

Editor's note: To watch *The Glazov Gang*'s recent discussion about the Muslim Brotherhood's infiltration of the United States and the Obama administration, see this week's episode below:

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Filed Under: Daily Mailer, FrontPage Tagged With: Denial, Islam, muslim brotherhood, Obama, Siegel, The Control Factor

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About Jamie Glazov

Jamie Glazov is Frontpage Magazine's editor. He holds a Ph.D. in History with a specialty in Russian, U.S. and Canadian foreign policy. He is the author of the critically acclaimed and best-selling, ***United in Hate: The Left's Romance with Tyranny and Terror.*** His new book is ***High No on For America.*** He is the host of Frontpage's television show, ***The Glazov Gang,*** and he can be reached at jamieglazov11@gmail.com. Visit his sit at ***JamieGlazov.com***.

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AdinaK 86p · *11 hours ago*

The war being waged has two components - mental and physical. The mental side is a minefield of constructs, deeply implanted within generations of Americans, and its PC chickens are coming home to roost. So much so, millions of Americans (westerners) cannot break free of its shackles. But it is not as if these mental chains magically appeared. Far from it - http://adinakutnicki.com/2012/11/26/the-death-of-...

In addition, the fault-lines of democracy allowed for the most retrograde forces, on this planet, to infiltrate and penetrate the body politic- http://adinakutnicki.com/2012/09/02/the-subversio...

IF the mental and physical constraints are not immediately removed, it is a given that western civilization will fall. Cause and effect.
Adina Kutnicki, Israel - http://adinakutnicki.com/about/

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1 reply · *active 30 minutes ago*

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dmw · *30 minutes ago*

And I would think one "phy sical constraint" is to not let them in in the first place. By & quot;them" I mean those who have allegiance to a socio-political system disguised as a religion that seeks world dominance by man imposed methodology/effort -- unlike Judaism and Christianity properly understood. If we are to "believe", the world already has a King and does not need a Caliph.

Report

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0

MikeWood · *6 hours ago*

Ground-breaking, brilliant. There are absolutely essentially lessons to be learned from this. Buy this book, read it, study it, and lend it to your friends and colleagues. Do it.

Report

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0

lambsev77 54p · *4 hours ago*

The fall of Rome... The fall of the 3rd Reich... The fall of Western Civilization...

oooooh... Scary!

How about the fall of humankind recorded in Genesis Chapter 3 and following?

We're ALL GONNA DIE! But will you rise with Christ?

Report

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+1

@WolfyJam · *2 hours ago*

Notice how celebrities basking in their narcissism think they can dictate culture to us while they live their lives in the comfort of their ivory castles. Mia farrow has no clue what the right to bear arms means and because of that she needs to shut the hell up. _As far as blacks go-- I grew up in the 70's coming home from Hallahan H.S. in Philadelphia, me and my small group of girls were swarmed by a mob of black girls who would kick and slap and pull hair without provocation. of course we would fight back but then that was back in the day when whites weren't sissies. Still I made excuses for them. Black men would get in my face for no other reason than to intimidate me. rocks were thrown a my car for no reason. So, in short, based on my experiences Blacks are the cause of racism and if they hate whites so much then they should stay away completely and totally. _

Report

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+1

@WolfyJam · *2 hours ago*

I read the Control factor and it was excellent. I wish more people would realize that our country is at its most vulnerable than ever in its history. the jihadis have basically taken over the inner cities. Islam's love for violence coupled with ignorance and narcissim are a recipe for disaster. I hope Americans wake up in time to save their future. I'm not optimistic though. I think its over but still I fight on.

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NEITHER THE GENERAL PARTNER NOR THE COMPANY IS REQUIRED TO REGISTER OR BE REGULATED AS A MUTUAL FUND UNDER THE MUTUAL FUNDS LAW (2003 REVISION) OF THE CAYMAN ISLANDS. NEITHER THE CAYMAN ISLANDS MONETARY AUTHORITY NOR ANY OTHER GOVERNMENTAL AUTHORITY IN THE CAYMAN ISLANDS HAS PASSED JUDGMENT UPON OR APPROVED THE TERMS OR MERITS OF THIS DOCUMENT. THERE IS NO INVESTMENT COMPENSATION SCHEME AVAILABLE TO INVESTORS IN THE CAYMAN ISLANDS.

PROSPECTIVE INVESTORS SHOULD READ THIS ENTIRE MEMORANDUM CAREFULLY BEFORE DECIDING WHETHER TO PURCHASE THE UNITS, AND PROSPECTIVE INVESTORS SHOULD MAKE THEIR OWN INVESTIGATION OF THE INVESTMENT DESCRIBED HEREIN, INCLUDING THE MERITS AND RISKS INVOLVED AND THE LEGALITY AND TAX CONSEQUENCES OF SUCH AN INVESTMENT. PROSPECTIVE INVESTORS ARE NOT TO CONSTRUE THIS MEMORANDUM OR ITS CONTENTS AS LEGAL, TAX, INVESTMENT OR OTHER ADVICE. PROSPECTIVE INVESTORS WILL HAVE THE OPPORTUNITY TO ASK QUESTIONS AND RECEIVE ANSWERS AND ADDITIONAL INFORMATION ABOUT THE COMPANY, THE GENERAL PARTNER AND THE UNITS TO VERIFY THE INFORMATION CONTAINED HEREIN TO THE EXTENT REPRESENTATIVES OF THE COMPANY POSSESS SUCH INFORMATION. EACH INVESTOR SHOULD MAKE ITS OWN INQUIRIES AND CONSULT ITS OWN ADVISORS CONCERNING THE VARIOUS LEGAL, TAX AND ECONOMIC CONSIDERATIONS RELATING TO ITS INVESTMENT.

THIS MEMORANDUM DOES NOT CONTAIN THE INFORMATION, INCLUDING FINANCIAL STATEMENTS, THAT WOULD BE INCLUDED IN A REGISTRATION STATEMENT FILED WITH THE U.S. SECURITIES AND EXCHANGE COMMISSION.

THIS MEMORANDUM CONTAINS PROJECTIONS FOR KLC AND *K12* INC. THAT ARE BASED UPON A NUMBER OF ASSUMPTIONS AND ESTIMATES THAT, WHILE PRESENTED WITH NUMERICAL SPECIFICITY AND CONSIDERED REASONABLE BY MANAGEMENT WHEN TAKEN AS A WHOLE, INHERENTLY ARE SUBJECT TO SIGNIFICANT BUSINESS, ECONOMIC, COMPETITIVE AND OTHER RISKS, UNCERTAINTIES AND CONTINGENCIES, MANY OF WHICH ARE BEYOND THE CONTROL OF THE COMPANY, AND ARE BASED UPON SPECIFIC ASSUMPTIONS WITH RESPECT TO FUTURE BUSINESS DECISIONS, SOME OR ALL OF WHICH WILL CHANGE. PROJECTIONS ARE NECESSARILY SPECULATIVE IN NATURE AND IT CAN BE EXPECTED THAT ASSUMPTIONS UNDERLYING THE PROJECTIONS WILL NOT PROVE TO BE VALID OR WILL VARY FROM ACTUAL RESULTS. ACCORDINGLY, THE PROJECTIONS ARE ONLY AN ESTIMATE. ACTUAL RESULTS WILL VARY FROM THE PROJECTIONS AND THE VARIATIONS MAY BE MATERIAL. CONSEQUENTLY, YOUR RECEIPT OF THE PROJECTIONS SHOULD NOT BE REGARDED AS A REPRESENTATION BY

THE COMPANY, ITS ADVISORS, THE AGENTS, OR ANY OTHER PERSON OF RESULTS THAT WILL ACTUALLY BE ACHIEVED. PROSPECTIVE PURCHASERS OF THE UNITS ARE CAUTIONED NOT TO PLACE UNDUE RELIANCE ON THESE PROJECTIONS.

THE INFORMATION PRESENTED HEREIN WAS PREPARED OR OBTAINED BY KUE AND IS BEING FURNISHED SOLELY FOR USE BY PROSPECTIVE INVESTORS IN CONNECTION WITH THE OFFERING. THE AGENTS HAVE NOT ASSUMED ANY RESPONSIBILITY FOR INDEPENDENT VERIFICATION OF THE INFORMATION CONTAINED HEREIN OR OTHERWISE MADE AVAILABLE IN CONNECTION WITH THE OFFERING OF SECURITIES AND MAKE NO REPRESENTATIONS OR WARRANTIES AS TO THE ACCURACY OR COMPLETENESS OF SUCH INFORMATION. NOTHING CONTAINED HEREIN IS, OR SHOULD BE RELIED ON AS, A PROMISE OR REPRESENTATION AS TO THE FUTURE PERFORMANCE OF KUE.

NOTICE TO NON-U.S. INVESTORS

NOTICE TO RESIDENTS OF ARGENTINA

THIS MEMORANDUM HAS NOT BEEN APPROVED BY ANY SECURITIES REGULATOR IN ARGENTINA AND DOES NOT ENABLE KUE, THE GENERAL PARTNER, OR ANY OTHER PARTY TO MAKE A PUBLIC OFFERING OF THE UNITS. THIS MEMORANDUM HAS ONLY BEEN ADDRESSED DIRECTLY TO THE PROSPECTIVE INVESTORS DESIGNATED AND IS INTENDED TO PROVIDE INFORMATION AT THEIR REQUEST. THIS MEMORANDUM SHOULD NOT BE CIRCULATED OR MADE PUBLIC IN ANY WAY. INVESTORS PARTICIPATING IN THIS ISSUANCE FULLY ACKNOWLEDGE THAT THEY HAVE BEEN INVITED PERSONALLY AND IN CONSIDERATION OF THEIR SPECIAL POSITION AS SOPHISTICATED INVESTORS AND THAT THEY HAVE HAD ALL PROPER AND DUE PERSONAL COUNSELING TO ADOPT ANY DECISION RELATED TO THIS ISSUANCE. THE UNITS ARE NOT AUTHORIZED TO BE OFFERED PUBLICLY IN THE ARGENTINEAN MARKET OR TO BE SOLD TO ANY INVESTOR IN ARGENTINA.

NOTICE TO RESIDENTS OF AUSTRALIA

THIS MEMORANDUM HAS NOT BEEN AND WILL NOT BE LODGED WITH THE AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION. THE OFFER IS ONLY MADE TO THOSE PERSONS TO WHOM DISCLOSURE IS NOT REQUIRED UNDER DIVISION 2 OF PART 6D.2 OR PART 7.9 OF THE CORPORATIONS ACT 2001 AND DOES NOT PURPORT TO BE AN OFFER OF INTERESTS FOR WHICH DISCLOSURE IS REQUIRED. IN ADDITION, KUE IS NOT A REGISTERED SCHEME AS DEFINED IN THE CORPORATIONS ACT 2001. RESALE OF THE UNITS IN AUSTRALIA WITHIN 12 MONTHS OF THE DATE OF ISSUE MAY REQUIRE THE SELLER TO COMPLY WITH THE DISCLOSURE REQUIREMENTS OF DIVISION 2 OF PART 6D.2 OR PART 7.9 OF THE CORPORATIONS ACT 2001.

NOTICE TO RESIDENTS OF BRAZIL

KUE IS NOT A PUBLICLY-HELD CORPORATION AND IS NOT LISTED WITH ANY STOCK EXCHANGE, ORGANIZED OVER THE COUNTER MARKET OR ELECTRONIC SYSTEM OF SECURITIES TRADING. LIKEWISE, THE UNITS HAVE NOT BEEN AND WILL NOT BE REGISTERED WITH ANY SECURITIES EXCHANGE COMMISSION OR OTHER SIMILAR AUTHORITY, INCLUDING THE BRAZILIAN SECURITIES AND EXCHANGE COMMISSION (COMISSÃO DE VALORES MOBILÁRIOS-"CVM"). ANY PUBLIC OFFERING, AS DEFINED UNDER BRAZILIAN LAWS AND REGULATIONS, OF THE UNITS IN BRAZIL IS NOT LEGAL WITHOUT SUCH PRIOR REGISTRATION UNDER LAW NR. 6.385/76. SUBSEQUENT TRADING OF THE UNITS IN BRAZIL IS ALLOWED ONLY BY MEANS OF PRIVATE TRANSACTIONS AND IS NOT SUBJECT TO REGISTRATION WITH THE CVM TO THE EXTENT THAT SUCH TRADING DOES NOT QUALIFY AS A PUBLIC OFFERING. IT SHOULD BE NOTED THAT A SELLER OF THE UNITS, HOWEVER, MAY BE ASKED BY THE PURCHASER TO COMPLY WITH PROCEDURAL REQUIREMENTS TO EVIDENCE PREVIOUS TITLE TO THE UNITS, AND MAY BE SUBJECT TO BRAZILIAN TAX ON CAPITAL GAINS WHICH MAY BE WITHHELD FROM THE SALE PRICE. PERSONS WISHING TO OFFER OR ACQUIRE THE UNITS

WITHIN BRAZIL SHOULD CONSULT WITH THEIR OWN COUNSEL AS TO THE APPLICABILITY OF THESE REGISTRATION REQUIREMENTS OR ANY EXEMPTION THEREFROM.

THIS MEMORANDUM IS CONFIDENTIAL AND INTENDED SOLELY FOR THE USE OF THE ADDRESSEE AND CANNOT BE DELIVERED OR DISCLOSED IN ANY MANNER WHATSOEVER TO ANY PERSON OR ENTITY OTHER THAN THE ADDRESSEE.

NOTICE TO RESIDENTS OF CANADA

THIS MEMORANDUM CONSTITUTES AN OFFERING OF THE UNITS DESCRIBED HEREIN ONLY IN THOSE JURISDICTIONS IN CANADA AND TO THOSE PERSONS WHERE AND TO WHOM THEY MAY BE LAWFULLY OFFERED FOR SALE AND THEREIN ONLY BY PERSONS PERMITTED TO SELL SUCH SECURITIES. THIS MEMORANDUM IS NOT, AND UNDER NO CIRCUMSTANCES IS TO BE CONSTRUED AS, AN ADVERTISEMENT OR A PUBLIC OFFERING OF THE UNITS IN CANADA. NO SECURITIES COMMISSION OR SIMILAR REGULATORY AUTHORITY IN CANADA HAS REVIEWED OR IN ANY WAY PASSED UPON THIS MEMORANDUM OR THE MERIT OF THE UNITS AND ANY REPRESENTATION TO THE CONTRARY IS AN OFFENCE UNDER APPLICABLE SECURITIES LAWS.

No dealer, salespersons or other individual has been authorized to give any information or to make any representations not contained in this Memorandum in connection with the offer made by this Memorandum and, if given or made, such information or representations must not be relied upon as having been authorized by KUE or by the General Partner or by any placement agent. Neither the delivery of this Memorandum nor any sale made hereunder shall, under any circumstances, create an implication that there has not been any change in the facts as set forth in this Memorandum or in the affairs of KUE or the General Partner since the date hereof.

Resale Restrictions in Canada. THE DISTRIBUTION OF THE UNITS IN CANADA IS BEING MADE ON A PRIVATE PLACEMENT BASIS. ACCORDINGLY, ANY RESALE OF THE UNITS MUST BE MADE IN ACCORDANCE WITH AN EXEMPTION FROM THE REGISTRATION AND PROSPECTUS REQUIREMENTS OF APPLICABLE SECURITIES LAWS. NEITHER KUE NOR THE GENERAL PARTNER IS A REPORTING ISSUER IN ANY PROVINCE OR TERRITORY OF CANADA. PURCHASERS OF THE UNITS ARE ADVISED TO SEEK LEGAL ADVICE PRIOR TO ANY RESALE OF THE UNITS.

Enforcement of Legal Rights. THE GENERAL PARTNER IS A CAYMAN ISLANDS EXEMPTED COMPANY AND KUE IS A CAYMAN ISLANDS EXEMPTED LIMITED PARTNERSHIP. THE DIRECTORS, OFFICERS AND REPRESENTATIVES OF THE GENERAL PARTNER AND KUE MAY BE LOCATED OUTSIDE CANADA AND, AS A RESULT, IT MAY NOT BE POSSIBLE FOR CANADIAN PURCHASERS TO EFFECT SERVICE OF PROCESS WITHIN CANADA UPON THE GENERAL PARTNER, KUE, OR THEIR DIRECTORS, OFFICERS OR REPRESENTATIVES. ALL OR A SUBSTANTIAL PORTION OF THE ASSETS OF KUE, THE GENERAL PARTNER AND THEIR DIRECTORS, OFFICERS OR REPRESENTATIVES MAY BE LOCATED OUTSIDE OF CANADA AND, AS A RESULT, IT MAY NOT BE POSSIBLE TO SATISFY A JUDGMENT AGAINST SUCH PERSONS IN CANADA OR TO ENFORCE A JUDGMENT OBTAINED IN CANADIAN COURTS AGAINST SUCH PERSONS OUTSIDE OF CANADA.

Right of Action for Damages or Rescission. THE FOLLOWING SUMMARY IS SUBJECT TO THE EXPRESS PROVISIONS OF THE SECURITIES ACT (ONTARIO), THE SECURITIES ACT (NEW BRUNSWICK) AND THE SECURITIES ACT (NOVA SCOTIA) AND THE RULES AND REGULATIONS THEREUNDER AND REFERENCE IS MADE THERETO FOR THE COMPLETE TEXT OF SUCH PROVISIONS. THE SECURITIES ACT (ONTARIO) AND THE SECURITIES ACT (NEW BRUNSWICK) PROVIDE CERTAIN PURCHASERS IN ONTARIO AND NEW BRUNSWICK, RESPECTIVELY, WITH A STATUTORY RIGHT OF ACTION FOR DAMAGES OR RESCISSION AGAINST THE ISSUER WHERE AN OFFERING MEMORANDUM CONTAINS A MISREPRESENTATION. THE SECURITIES ACT (NOVA SCOTIA) PROVIDES PURCHASERS IN NOVA SCOTIA WITH A STATUTORY RIGHT OF ACTION FOR DAMAGES AGAINST EVERY SELLER, EVERY DIRECTOR OF THE SELLER AT THE DATE OF THIS

MEMORANDUM AND EVERY PERSON WHO SIGNED THE OFFERING MEMORANDUM OR A RIGHT OF RESCISSION AGAINST EVERY SELLER WHERE AN OFFERING MEMORANDUM CONTAINS A MISREPRESENTATION. SUCH PURCHASERS WHO PURCHASE A SECURITY OFFERED BY THE OFFERING MEMORANDUM DURING THE PERIOD OF DISTRIBUTION ARE DEEMED TO HAVE RELIED ON SUCH MISREPRESENTATION IF IT WAS A MISREPRESENTATION AT THE TIME OF PURCHASE.

FOR PURCHASERS IN ONTARIO AND NOVA SCOTIA, THESE STATUTORY RIGHTS ARE EXERCISABLE, IN THE CASE OF AN ACTION FOR RESCISSION, 180 DAYS AFTER THE DATE OF THE TRANSACTION THAT GAVE RISE TO THE CAUSE OF ACTION OR, IN THE CASE OF ANY ACTION, OTHER THAN AN ACTION FOR RESCISSION, THE EARLIER OF (I) 180 DAYS AFTER THE PLAINTIFF FIRST HAD KNOWLEDGE OF THE FACTS GIVING RISE TO THE CAUSE OF ACTION AND (II) THREE YEARS AFTER THE DATE OF THE TRANSACTION THAT GAVE RISE TO THE CAUSE OF ACTION. NOTWITHSTANDING THE FOREGOING, IN NOVA SCOTIA, NO ACTION MAY BE COMMENCED MORE THAN 120 DAYS AFTER THE DATE ON WHICH PAYMENT WAS MADE FOR THE SECURITIES OR AFTER THE DATE ON WHICH THE INITIAL PAYMENT FOR THE SECURITIES WAS MADE WHERE PAYMENTS SUBSEQUENT TO THE INITIAL PAYMENT ARE MADE PURSUANT TO A CONTRACTUAL COMMITMENT ASSUMED PRIOR TO, OR CONCURRENTLY WITH, THE INITIAL PAYMENT.

FOR PURCHASERS IN NEW BRUNSWICK, THESE STATUTORY RIGHTS ARE EXERCISABLE, IN THE CASE OF AN ACTION FOR RESCISSION, 180 DAYS AFTER THE DATE OF THE TRANSACTION THAT GAVE RISE TO THE CAUSE OF ACTION OR, IN THE CASE OF ANY ACTION, OTHER THAN AN ACTION FOR RESCISSION, THE EARLIER OF (I) ONE YEAR AFTER THE PLAINTIFF FIRST HAD KNOWLEDGE OF THE FACTS GIVING RISE TO THE CAUSE OF ACTION AND (II) 6 YEARS AFTER THE DATE OF THE TRANSACTION THAT GAVE RISE TO THE CAUSE OF THE ACTION.

THE RIGHTS DISCUSSED ABOVE ARE IN ADDITION TO AND WITHOUT DEROGATION FROM ANY OTHER RIGHT OR REMEDY WHICH PURCHASERS MAY HAVE AT LAW AND ARE INTENDED TO CORRESPOND TO THE PROVISIONS OF THE RELEVANT SECURITIES LEGISLATION AND ARE SUBJECT TO THE DEFENCES CONTAINED THEREIN.

Canadian Federal Income Tax Considerations. THIS MEMORANDUM DOES NOT DISCUSS THE CANADIAN FEDERAL INCOME TAX CONSIDERATIONS RELEVANT TO A HOLDER OF THE UNITS RESIDENT IN CANADA FOR PURPOSES OF THE *INCOME TAX ACT* (CANADA) (THE "ITA"). THE RULES FOR THE TAXATION OF PARTNERS AND PARTNERSHIPS UNDER THE ITA ARE EXTREMELY COMPLEX AND, ACCORDINGLY, PROSPECTIVE PURCHASERS OF THE UNITS WHO ARE RESIDENT IN CANADA ARE STRONGLY ADVISED TO CONSULT WITH THEIR OWN TAX ADVISORS PRIOR TO PURCHASING ANY UNITS.

Forward Looking Statements. CERTAIN STATEMENTS IN THIS MEMORANDUM CONSTITUTE "FORWARD-LOOKING STATEMENTS." FORWARD-LOOKING STATEMENTS INCLUDE STATEMENTS CONCERNING THE PLANS, OBJECTIVES, GOALS, STRATEGIES AND FUTURE OPERATIONS AND PERFORMANCE OF KUE AND THE GENERAL PARTNER AND THE ASSUMPTIONS UNDERLYING THESE FORWARD-LOOKING STATEMENTS. KUE AND THE GENERAL PARTNER USE THE WORDS "ANTICIPATES," "ESTIMATES," EXPECTS," "BELIEVES," "INTENDS," "PLANS," "MAY," "WILL," "SHOULD," AND ANY SIMILAR EXPRESSIONS TO IDENTIFY FORWARD-LOOKING STATEMENTS. THESE FORWARD-LOOKING STATEMENTS INVOLVE KNOWN AND UNKNOWN RISKS, UNCERTAINTIES AND OTHER IMPORTANT FACTORS THAT COULD CAUSE ACTUAL RESULTS, PERFORMANCE AND ACHIEVEMENTS TO BE MATERIALLY DIFFERENT FROM ANY FUTURE RESULTS, PERFORMANCE OR ACHIEVEMENTS EXPRESSED OR IMPLIED BY SUCH FORWARD-LOOKING STATEMENTS. SUCH FORWARD-LOOKING STATEMENTS ARE BASED ON NUMEROUS ASSUMPTIONS REGARDING PRESENT AND FUTURE BUSINESS STRATEGIES AND THE ENVIRONMENT IN WHICH KUE AND THE GENERAL PARTNER WILL OPERATE IN THE FUTURE. AS A RESULT OF THESE RISK, UNCERTAINTIES AND

ABOUT THE OSC'S INDIRECT COLLECTION OF SUCH PERSONAL INFORMATION IS THE ADMINISTRATIVE ASSISTANT TO THE DIRECTOR OF CORPORATE FINANCE AT THE OSC, SUITE 1903, BOX 5520 QUEEN STREET WEST, TORONTO, ONTARIO M5H 3S8, TELEPHONE: (416) 593-8086; AND (B) HAS AUTHORIZED THE INDIRECT COLLECTION OF THE PERSONAL INFORMATION BY THE OSC. FURTHER, THE PURCHASER ACKNOWLEDGES THAT ITS NAME, ADDRESS, TELEPHONE NUMBER AND OTHER SPECIFIED INFORMATION, INCLUDING THE NUMBER OF UNITS IT HAS PURCHASED AND THE AGGREGATE PURCHASE PRICE PAID BY PURCHASER, MAY BE DISCLOSED TO OTHER CANADIAN SECURITIES REGULATORY AUTHORITIES AND MAY BECOME AVAILABLE TO THE PUBLIC IN ACCORDANCE WITH THE REQUIREMENTS OF APPLICABLE LAWS. BY PURCHASING UNITS, THE PURCHASER CONSENTS TO THE DISCLOSURE OF SUCH INFORMATION.

Language of documents in Canada. UPON RECEIPT OF THIS MEMORANDUM, EACH INVESTOR IN CANADA HEREBY CONFIRMS THAT IT HAS EXPRESSLY REQUESTED THAT ALL DOCUMENTS EVIDENCING OR RELATING IN ANY WAY TO THE SALE OF THE UNITS (INCLUDING FOR GREATER CERTAINTY ANY PURCHASE CONFIRMATION OR ANY NOTICE) BE DRAWN UP IN THE ENGLISH LANGUAGE ONLY. *PAR LA RÉCEPTION DE CE DOCUMENT, CHAQUE INVESTISSEUR CANADIEN CONFIRME PAR LES PRÉSENTES QU'IL A EXPRESSÉMENT EXIGÉ QUE TOUS LES DOCUMENTS FAISANT FOI OU SE RAPPORTANT DE QUELQUE MANIÈRE QUE CE SOIT À LA VENTE DES VALEURS MOBILIÈRES DÉCRITES AUX PRÉSENTES (INCLUANT, POUR PLUS DE CERTITUDE, TOUTE CONFIRMATION D'ACHAT OU TOUT AVIS) SOIENT RÉDIGÉS EN ANGLAIS SEULEMENT.*

NOTICE TO RESIDENTS OF THE CAYMAN ISLANDS

CLASS A SHARES IN THE GENERAL PARTNER AND COMMON LP UNITS IN KUE MAY BE BENEFICIALLY OWNED BY PERSONS RESIDENT, DOMICILED, ESTABLISHED, INCORPORATED OR REGISTERED IN THE CAYMAN ISLANDS PURSUANT TO THE LAWS OF THE CAYMAN ISLANDS. THE GENERAL PARTNER AND KUE, HOWEVER, WILL NOT UNDERTAKE BUSINESS WITH THE PUBLIC IN THE CAYMAN ISLANDS OTHER THAN SO FAR AS MAY BE NECESSARY FOR THE CARRYING ON OF THE BUSINESS OF, AS APPLICABLE, THE GENERAL PARTNER OR KUE EXTERIOR TO THE ISLANDS. "PUBLIC" FOR THESE PURPOSES DOES NOT INCLUDE ANY EXEMPTED OR ORDINARY NON-RESIDENT COMPANY REGISTERED UNDER THE COMPANIES LAW OR A FOREIGN COMPANY REGISTERED PURSUANT TO PART IX OF THE COMPANIES LAW OR ANY SUCH COMPANY ACTING AS GENERAL PARTNER OF A PARTNERSHIP REGISTERED PURSUANT TO SECTION 9(1) OF THE EXEMPTED LIMITED PARTNERSHIP LAW (2003 REVISION) OR ANY DIRECTOR OR OFFICER OF SUCH PARTNERSHIP ACTING IN SUCH CAPACITY OR THE TRUSTEE OF ANY TRUST REGISTERED OR CAPABLE OF REGISTRATION PURSUANT TO SECTION 74 OF THE TRUSTS LAW (2001 REVISION).

NOTICE TO RESIDENTS OF CHINA

THE INFORMATION CONTAINED IN THIS MEMORANDUM WILL NOT CONSTITUTE AN OFFER TO SELL ANY SECURITIES WITHIN THE PEOPLE'S REPUBLIC OF CHINA (WHICH, FOR SUCH PURPOSES, DOES NOT INCLUDE THE HONG KONG OR MACAU SPECIAL ADMINISTRATIVE REGIONS OR TAIWAN) (THE "PRC"). THIS MEMORANDUM AND THE INFORMATION CONTAINED HEREIN HAVE NOT BEEN APPROVED BY ANY RELEVANT GOVERNMENTAL AUTHORITIES IN THE PRC AND THE UNITS MAY NOT BE OFFERED FOR SALE IN THE PRC. PRC INVESTORS ARE RESPONSIBLE FOR OBTAINING ALL RELEVANT GOVERNMENT REGULATORY APPROVALS/LICENSES THEMSELVES, INCLUDING, BUT NOT LIMITED TO, ANY WHICH MAY BE REQUIRED FROM THE STATE ADMINISTRATION OF FOREIGN EXCHANGE, THE CHINA BANKING REGULATORY COMMISSION, AND/OR THE CHINA SECURITIES REGULATORY COMMISSION, AND COMPLYING WITH ALL RELEVANT PRC REGULATIONS, INCLUDING, BUT NOT LIMITED TO, ANY RELEVANT FOREIGN EXCHANGE REGULATIONS AND/OR FOREIGN INVESTMENT REGULATIONS.

NOTICE TO RESIDENTS OF FRANCE

THE COMPANY AND THE AGENTS HAVE NOT OFFERED OR SOLD AND WILL NOT OFFER OR SELL, DIRECTLY OR INDIRECTLY, THE UNITS TO THE PUBLIC IN FRANCE, AND HAVE NOT DISTRIBUTED OR CAUSED TO BE DISTRIBUTED AND WILL NOT DISTRIBUTE OR CAUSE TO BE DISTRIBUTED TO THE PUBLIC IN FRANCE, THIS MEMORANDUM OR ANY OTHER OFFERING MATERIAL RELATING TO THE UNITS. SUCH OFFERS, SALES AND DISTRIBUTIONS HAVE BEEN AND SHALL ONLY BE MADE IN FRANCE TO (I) PROVIDERS OF INVESTMENT SERVICES RELATING TO PORTFOLIO MANAGEMENT FOR THE ACCOUNT OF THIRD PARTIES, AND/OR (II) QUALIFIED INVESTORS (INVESTISSEURS QUALIFIÉS), AND/OR (III) A RESTRICTED GROUP OF INVESTORS (CERCLE RESTREINT D'INVESTISSEURS), ALL AS DEFINED IN, AND IN ACCORDANCE WITH, ARTICLES L.411-1, L.411-2, D.411-1 AND D.411-2 OF THE FRENCH CODE MONÉTAIRE ET FINANCIER.

NOTICE TO RESIDENTS OF GERMANY

THE UNITS HAVE NOT BEEN AND WILL NOT BE REGISTERED OR APPROVED FOR PUBLIC OFFERING UNDER THE SECURITIES LAWS OF GERMANY. THIS MEMORANDUM HAS NOT BEEN AND WILL NOT BE SUBMITTED TO THE FEDERAL FINANCIAL SERVICES SUPERVISORY AUTHORITY (BUNDESANSTALT FÜR FINANZDIENSTLEISTUNGSAUFSICHT) FOR APPROVAL AS A PROSPECTUS AND NO PROSPECTUS HAS BEEN OR WILL BE PUBLISHED IN GERMANY. THEREFORE, THE UNITS MAY BE OFFERED AND SOLD IN THE TERRITORY OF THE FEDERAL REPUBLIC OF GERMANY ONLY IF (I) LESS THAN 20 UNITS ARE OFFERED IN GERMANY, (II) THE PRICE PER OFFERED UNIT IS AT LEAST €200,000 FOR EACH OFFEREE, (III) THE OFFER IS TO A "RESTRICTED CIRCLE OF PERSONS" AS THIS TERM IS INTERPRETED BY THE BAFIN AND THE GERMAN COURTS, OR (IV) THE OFFER IS TO INVESTORS WHO PURCHASE OR SELL SECURITIES OR INVESTMENTS (VERMÖGENSANLAGEN) AS DEFINED IN THE GERMAN SALES PROSPECTUS ACT (VERKAUFSPROSPEKTGESETZ) FOR THEIR OWN ACCOUNT OR THE ACCOUNT OF THIRD PARTIES AS PART OF THEIR PROFESSION OR TRADE. THIS MEMORANDUM AND ANY OTHER DOCUMENT RELATING TO THE UNITS, AS WELL AS INFORMATION CONTAINED THEREIN, MAY NOT BE SUPPLIED TO THE PUBLIC IN GERMANY OR USED IN CONNECTION WITH ANY OFFER FOR SUBSCRIPTION OR SALE OF THE UNITS TO THE PUBLIC IN GERMANY. THIS MEMORANDUM AND OTHER OFFERING MATERIALS RELATING TO THE OFFER OF THE UNITS ARE STRICTLY CONFIDENTIAL AND MAY NOT BE DISTRIBUTED TO ANY PERSON OR ENTITY OTHER THAN THE RECIPIENTS HEREOF.

NOTICE TO RESIDENTS OF HONG KONG

WARNING

THE CONTENTS OF THIS MEMORANDUM HAVE NOT BEEN REVIEWED BY ANY REGULATORY AUTHORITY IN HONG KONG. YOU ARE ADVISED TO EXERCISE CAUTION IN RELATION TO THE OFFER. IF YOU ARE IN ANY DOUBT ABOUT ANY OF THE CONTENTS OF THIS MEMORANDUM, YOU SHOULD OBTAIN INDEPENDENT PROFESSIONAL ADVICE.

NOTICE TO RESIDENTS OF ICELAND

THIS MEMORANDUM HAS BEEN ISSUED TO YOU FOR YOUR PERSONAL USE ONLY AND EXCLUSIVELY FOR THE PURPOSES OF THE INVESTMENT SCHEME. ACCORDINGLY, THIS MEMORANDUM MAY NOT BE USED FOR ANY OTHER PURPOSE NOR PASSED ON TO ANY OTHER PERSON IN ICELAND. THE SECURITIES OFFERING DESCRIBED IN THIS MEMORANDUM IS AN UNREGULATED INVESTMENT SCHEME. THE SECURITIES WHICH ARE THE OBJECT OF THIS MEMORANDUM ARE NOT REGISTERED FOR PUBLIC DISTRIBUTION IN ICELAND WITH THE FINANCIAL SUPERVISORY AUTHORITY PURSUANT TO THE ICELANDIC ACT ON SECURITIES TRANSACTIONS NO. 33/2003 OR THE ICELANDIC ACT ON UCITS-FUNDS AND OTHER INVESTMENT FUNDS NO. 30/2003 AND SUPPLEMENTARY REGULATIONS. THE UNITS MAY NOT BE OFFERED OR SOLD BY MEANS OF THIS MEMORANDUM OR ANYWAY LATER RESOLD TO

OTHER THAN ENTITIES OR PERSONS DEFINED AS INSTITUTIONAL INVESTORS IN THE MEANING OF ITEM NO. 7. IN ARTICLE 2 OF THE ICELANDIC ACT ON SECURITIES TRANSACTIONS AND THE REGULATION OF THE TRANSACTIONS OF SECURITIES NO. 233/2003. ANY RESALE OF THE UNITS IN ICELAND WILL NEED TO TAKE PLACE IN ACCORDANCE WITH THE PROVISIONS OF THE ICELANDIC ACT ON SECURITIES TRANSACTIONS No. 33/2003 AS AMENDED AND ANY APPLICABLE LAWS OR REGULATIONS OF ICELAND.

NOTICE TO RESIDENTS OF INDIA

THE ISSUANCE OF THE UNITS IS BEING MADE STRICTLY ON A PRIVATE PLACEMENT BASIS. THIS MEMORANDUM IS NOT A PROSPECTUS OR A STATEMENT IN LIEU OF A PROSPECTUS. IT IS NOT, AND SHOULD NOT BE DEEMED TO CONSTITUTE AN OFFER TO THE PUBLIC IN GENERAL.

THE INFORMATION CONTAINED IN THIS MEMORANDUM IS BELIEVED BY THE COMPANY TO BE ACCURATE IN ALL MATERIAL RESPECTS AS OF THE DATE HEREOF. THE COMPANY DOES NOT UNDERTAKE TO UPDATE THIS MEMORANDUM TO REFLECT SUBSEQUENT EVENTS. THIS MEMORANDUM HAS BEEN PREPARED TO PROVIDE GENERAL INFORMATION ON THE COMPANY TO POTENTIAL INVESTORS EVALUATING THE PROPOSAL TO SUBSCRIBE FOR THE UNITS COVERED BY THIS MEMORANDUM AND IT DOES NOT PURPORT TO CONTAIN ALL THE INFORMATION THAT ANY SUCH POTENTIAL INVESTOR MAY REQUIRE. POTENTIAL INVESTORS SHOULD CONDUCT THEIR OWN DUE DILIGENCE, INVESTIGATION AND ANALYSIS OF THE COMPANY.

PRIOR TO APPLYING FOR THE UNITS, INVESTORS SHOULD VERIFY IF THEY HAVE THE NECESSARY POWER AND COMPETENCE TO APPLY FOR THE UNITS UNDER THEIR CONSTITUTIONAL DOCUMENTS AS WELL AS ALL RELEVANT LAWS AND REGULATIONS IN FORCE IN INDIA. THEY SHOULD ALSO CONSULT THEIR OWN TAX ADVISORS ON THE TAX IMPLICATIONS OF THE ACQUISITION, OWNERSHIP AND SALE OF THE UNITS, AND INCOME ARISING THEREON.

ALTHOUGH THE INFORMATION CONTAINED HEREIN HAS BEEN OBTAINED FROM SOURCES THAT ARE RELIABLE TO THE BEST OF THE AGENTS' KNOWLEDGE AND BELIEF, THE AGENTS MAKES NO REPRESENTATION AS TO THE ACCURACY OR COMPLETENESS OF ANY INFORMATION CONTAINED HEREIN OR OTHERWISE PROVIDED BY THE AGENT. NEITHER THE AGENTS NOR ANY OFFICER OR EMPLOYEE OF THE AGENTS ACCEPT ANY LIABILITY WHATSOEVER FOR ANY DIRECT OR CONSEQUENTIAL LOSS ARISING FROM ANY USE OF THIS MEMORANDUM OR ITS CONTENTS.

NOTICE TO RESIDENTS OF ITALY

THE OFFERING OF THE UNITS IN THE REPUBLIC OF ITALY ("ITALY") HAS NOT BEEN AUTHORISED BY THE COMMISSIONE NAZIONALE PER LE SOCIETÀ E LA BORSA ("CONSOB") PURSUANT TO THE ITALIAN SECURITIES LEGISLATION AND, ACCORDINGLY:

(I) THE UNITS CANNOT BE OFFERED, SOLD OR DELIVERED IN ITALY IN AN INVESTMENT SOLICITATION ("SOLLECITAZIONE ALL'INVESTIMENTO") WITHIN THE MEANING OF ARTICLE 1, PARAGRAPH 1, LETTER (T) OF LEGISLATIVE DECREE NO. 58 OF 24 FEBRUARY 1998, AS AMENDED ("DECREE 58/98"),

(II) THE UNITS CANNOT BE OFFERED, SOLD AND/OR DELIVERED, NOR ANY DOCUMENT RELATING TO THE UNITS CAN BE DISTRIBUTED, EITHER IN THE PRIMARY OR SECONDARY MARKET, TO INDIVIDUALS RESIDENT IN ITALY, AND

(III) ANY OFFER, SALE AND/OR DELIVERY OF THE UNITS AND DISTRIBUTION OF COPIES OF ANY DOCUMENT RELATING TO THE UNITS IN ITALY WILL ONLY BE:

(A) MADE TO ITALIAN INSTITUTIONAL INVESTORS ("INVESTITORI ISTITUZIONALI"), AS DEFINED IN ARTICLE 100 OF DECREE 58/98 BY REFERENCE TO ARTICLE 31.2 OF CONSOB REGULATION NO. 11522 OF 1 JULY 1998, AS AMENDED ("REGULATION 11522/98");

(B) MADE IN COMPLIANCE WITH ARTICLE 129 OF THE LEGISLATIVE DECREE NO. 385 OF 1 SEPTEMBER 1993, AS AMENDED ("DECREE 385/93"), AND THE IMPLEMENTING INSTRUCTIONS OF THE BANK OF ITALY, IF APPLICABLE, PURSUANT TO WHICH THE ISSUE OR PLACEMENT OF SECURITIES IN ITALY IS SUBJECT TO PRIOR NOTIFICATION TO THE BANK OF ITALY, UNLESS AN EXEMPTION, DEPENDING, INTER ALIA, ON THE AMOUNT OF THE ISSUE AND THE CHARACTERISTICS OF THE SECURITIES, APPLIES;

(C) MADE IN COMPLIANCE WITH ANY OTHER ITALIAN SECURITIES, TAX AND EXCHANGE CONTROL AND OTHER APPLICABLE LAWS AND REGULATIONS AND ANY OTHER APPLICABLE REQUIREMENT OR LIMITATION WHICH MAY BE IMPOSED BY CONSOB, THE BANK OF ITALY OR ANY OTHER COMPETENT ITALIAN AUTHORITY; AND

(D) MADE BY AN INVESTMENT FIRM, BANK OR FINANCIAL INTERMEDIARY PERMITTED TO CONDUCT SUCH ACTIVITIES IN ITALY IN ACCORDANCE WITH DECREE 58/98, DECREE 385/93, REGULATION 11522/98 AND ANY OTHER APPLICABLE LAWS AND REGULATIONS.

NOTICE TO RESIDENTS OF JAPAN

THE OFFERING OF THE UNITS HEREUNDER HAS NOT BEEN AND WILL NOT BE REGISTERED UNDER THE SECURITIES AND EXCHANGE LAW OF JAPAN. CONSEQUENTLY, THE UNITS MAY NOT BE OFFERED, SOLD, RESOLD OR OTHERWISE TRANSFERRED, DIRECTLY OR INDIRECTLY, IN JAPAN OR TO OR FOR THE ACCOUNT OF ANY RESIDENT OF JAPAN, EXCEPT PURSUANT TO AND IN COMPLIANCE WITH APPLICABLE JAPANESE LAWS AND REGULATIONS. THE INVESTORS SHOULD FURTHER NOTE THAT PURSUANT TO THE PARTNERSHIP AGREEMENT THE UNITS MAY ONLY BE TRANSFERRED IN WHOLE AND NOT IN PART AND THAT ANY SUCH TRANSFER WILL REQUIRE A PRIOR WRITTEN CONSENT OF THE GENERAL PARTNER.

NOTICE TO RESIDENTS OF JERSEY

NOTHING IN THIS MEMORANDUM, NOR ANYTHING COMMUNICATED TO HOLDERS OR POTENTIAL HOLDERS OF SECURITIES BY THE COMPANY OR THE AGENTS IS INTENDED TO CONSTITUTE OR SHOULD BE CONSTRUED AS ADVICE ON THE MERITS OF THE PURCHASE OF OR SUBSCRIPTION FOR THE UNITS OR THE EXERCISE OF ANY RIGHTS ATTACHED THERETO FOR THE PURPOSES OF THE FINANCIAL SERVICES (JERSEY) LAW 1998, AS AMENDED.

NOTICE TO RESIDENTS OF KUWAIT

THIS OFFERING HAS NOT BEEN APPROVED BY THE KUWAIT CENTRAL BANK OR THE KUWAIT MINISTRY OF COMMERCE AND INDUSTRY, NOR HAS THE COMPANY RECEIVED AUTHORIZATION OR LICENSING FROM THE KUWAIT CENTRAL BANK OR THE KUWAIT MINISTRY OF COMMERCE AND INDUSTRY TO MARKET OR SELL THE UNITS WITHIN KUWAIT. FURTHERMORE, THIS MEMORANDUM DOES NOT CONSTITUTE THE MARKETING OR OFFERING OF SECURITIES IN KUWAIT PURSUANT TO THE KUWAITI SECURITIES LAW (LAW NO. 31 OF 1990, AS AMENDED).

NOTICE TO RESIDENTS OF MEXICO

THE UNITS HAVE NOT BEEN REGISTERED WITH THE NATIONAL REGISTRY OF SECURITIES (*REGISTRO NACIONAL DE VALORES*) MAINTAINED BY THE MEXICAN NATIONAL BANKING AND SECURITIES COMMISSION (*COMISION NACIONAL BANCARIA Y DE VALORES*) AND MAY NOT BE OFFERED OR SOLD PUBLICLY IN MEXICO. THIS OFFER DOES NOT CONSTITUTE A PUBLIC OFFER UNDER THE MEXICAN SECURITIES MARKET LAW (*LEY DEL MERCADO DE VALORES*). THIS PRIVATE OFFER AND ALL OTHER INFORMATION AS CONTAINED IN THIS MEMORANDUM ARE EXCLUSIVELY FOR THE BENEFIT OF AND DISTRIBUTION TO INSTITUTIONAL OR HIGH NET

WORTH INVESTORS. THIS MEMORANDUM AND OTHER OFFERING MATERIALS MAY NOT BE PUBLICLY DISTRIBUTED IN MEXICO.

NOTICE TO RESIDENTS OF MONACO

NEITHER THIS MEMORANDUM NOR ANY OTHER OFFERING MATERIAL RELATING TO THE UNITS MAY BE AVAILABLE TO THE PUBLIC OR USED IN CONNECTION WITH ANY OTHER OFFER FOR SUBSCRIPTION OR SALE OF THE UNITS IN THE PRINCIPALITY OF MONACO, AND THE UNITS MAY NOT BE ISSUED, OFFERED OR OTHERWISE SOLD IN THE PRINCIPALITY OF MONACO.

NOTICE TO RESIDENTS OF THE NETHERLANDS

THE UNITS MAY ONLY BE OFFERED, DIRECTLY OR INDIRECTLY, IN THE NETHERLANDS TO ENTITIES WHICH (i) ARE PROFESSIONAL MARKET PARTIES AS DEFINED IN ARTICLE I-C, 1ST PARAGRAPH, UNDER A OF THE EXEMPTION REGULATION ISSUED PURSUANT TO ARTICLE 4 OF THE ACT ON THE SUPERVISION OF SECURITIES TRADE (WET TOEZICHT EFFECTENVERKEER 1995) AND (ii) WHICH TRADE OR INVEST IN INVESTMENT OBJECTS IN THE CONDUCT OF A PROFESSION OR BUSINESS WITHIN THE MEANING OF ARTICLE I OF THE EXEMPTION REGULATION OF 9 OCTOBER 1990 ISSUED PURSUANT TO ARTICLE 14 OF THE INVESTMENT INSTITUTION SUPERVISION ACT (WET TOEZICHT BELEGGINGSINSTELLINGEN OF JUNE 27, 1990). THE UNITS MAY NOT OTHERWISE BE OFFERED, DIRECTLY OR INDIRECTLY, IN THE NETHERLANDS.

NOTICE TO RESIDENTS OF QATAR

THE UNITS HAVE NOT BEEN OFFERED, SOLD OR DELIVERED, AND WILL NOT BE OFFERED, SOLD OR DELIVERED AT ANY TIME, DIRECTLY OR INDIRECTLY, IN THE STATE OF QATAR IN A MANNER THAT WOULD CONSTITUTE A PUBLIC OFFERING. THIS MEMORANDUM HAS NOT BEEN REVIEWED OR REGISTERED WITH QATARI GOVERNMENT AUTHORITIES, WHETHER UNDER LAW. NO. 25 (2002) CONCERNING INVESTMENT FUNDS, CENTRAL BANK RESOLUTION NO. 15 (1997), AS AMENDED, OR ANY ASSOCIATED REGULATIONS. THEREFORE, THIS MEMORANDUM IS STRICTLY PRIVATE AND CONFIDENTIAL, AND IS BEING ISSUED TO A LIMITED NUMBER OF SOPHISTICATED INVESTORS, AND MAY NOT BE REPRODUCED OR USED FOR ANY OTHER PURPOSE, NOR PROVIDED TO ANY PERSON OTHER THAN RECIPIENT THEREOF.

NOTICE TO RESIDENTS OF RUSSIA

UNDER RUSSIAN LAW, THE UNITS ARE SECURITIES OF A FOREIGN ISSUER. NEITHER THE ISSUE OF THE UNITS NOR A SECURITIES PROSPECTUS IN RESPECT OF THE UNITS HAS BEEN, OR IS INTENDED TO BE, REGISTERED WITH THE FEDERAL SERVICE FOR FINANCIAL MARKETS OF THE RUSSIAN FEDERATION, AND HENCE THE UNITS ARE NOT ELIGIBLE FOR INITIAL OFFERING OR PUBLIC CIRCULATION IN THE RUSSIAN FEDERATION. THE INFORMATION PROVIDED IN THIS MEMORANDUM IS NOT AN OFFER, OR AN INVITATION TO MAKE OFFERS, TO SELL, EXCHANGE OR OTHERWISE TRANSFER THE UNITS IN THE RUSSIAN FEDERATION OR TO OR FOR THE BENEFIT OF ANY RUSSIAN PERSON OR ENTITY.

EACH OF THE AGENTS HAS REPRESENTED AND AGREED THAT IT HAS NOT OFFERED OR SOLD AND WILL NOT OFFER OR SELL ANY UNITS TO OR FOR THE BENEFIT OF ANY PERSONS RESIDENT, INCORPORATED, ESTABLISHED OR HAVING THEIR USUAL RESIDENCE IN RUSSIA OR TO ANY PERSON LOCATED WITHIN THE TERRITORY OF RUSSIA UNLESS AND TO THE EXTENT OTHERWISE PERMITTED UNDER RUSSIAN LAW.

NOTICE TO RESIDENTS OF SAUDI ARABIA

THIS MEMORANDUM MAY NOT BE DISTRIBUTED IN THE KINGDOM EXCEPT TO THE EXTENT PERMITTED UNDER THE RULES GOVERNING EXEMPT OFFERS AS SET FORTH IN THE OFFERS

OF SECURITIES REGULATIONS (THE "REGULATIONS"). IT SHOULD NOT BE DISTRIBUTED TO ANY OTHER PERSON, OR RELIED UPON BY ANY OTHER PERSON.

THE CAPITAL MARKET AUTHORITY DOES NOT TAKE ANY RESPONSIBILITY FOR THE CONTENTS OF THIS MEMORANDUM, DOES NOT MAKE ANY REPRESENTATION AS TO ITS ACCURACY OR COMPLETENESS, AND EXPRESSLY DISCLAIMS ANY LIABILITY WHATSOEVER FOR ANY LOSS ARISING FROM, OR INCURRED IN RELIANCE UPON, ANY PART OF THIS MEMORANDUM. PROSPECTIVE PURCHASERS OF THE SECURITIES OFFERED HEREBY SHOULD CONDUCT THEIR OWN DUE DILIGENCE ON THE ACCURACY OF THE INFORMATION RELATING TO THE SECURITIES. IF YOU DO NOT UNDERSTAND THE CONTENTS OF THIS DOCUMENT YOU SHOULD CONSULT AN AUTHORIZED FINANCIAL ADVISER.

NOTICE TO RESIDENTS OF SINGAPORE

As to the Class A Shares

THIS MEMORANDUM HAS NOT BEEN REGISTERED AS A PROSPECTUS WITH THE MONETARY AUTHORITY OF SINGAPORE. ACCORDINGLY, THIS MEMORANDUM AND ANY OTHER DOCUMENT OR MATERIAL IN CONNECTION WITH THE OFFER OR SALE, OR INVITATION FOR SUBSCRIPTION OR PURCHASE, OF CLASS A SHARES MAY NOT BE CIRCULATED OR DISTRIBUTED, NOR MAY SUCH CLASS A SHARES BE OFFERED OR SOLD, OR BE MADE THE SUBJECT OF AN INVITATION FOR SUBSCRIPTION OR PURCHASE, WHETHER DIRECTLY OR INDIRECTLY, TO PERSONS IN SINGAPORE OTHER THAN (I) TO AN INSTITUTIONAL INVESTOR UNDER SECTION 274 OF THE SECURITIES AND FUTURES ACT, CHAPTER 289 OF SINGAPORE (THE "SFA"), (II) TO A RELEVANT PERSON, OR ANY PERSON PURSUANT TO SECTION 275(1A), AND IN ACCORDANCE WITH THE CONDITIONS, SPECIFIED IN SECTION 275 OF THE SFA OR (III) OTHERWISE PURSUANT TO, AND IN ACCORDANCE WITH THE CONDITIONS OF, ANY OTHER APPLICABLE PROVISION OF THE SFA.

WHERE SUCH CLASS A SHARES ARE SUBSCRIBED OR PURCHASED UNDER SECTION 275 BY A RELEVANT PERSON WHICH IS:

(A) A CORPORATION (WHICH IS NOT AN ACCREDITED INVESTOR (AS DEFINED IN SECTION 4A OF THE SFA)) THE SOLE BUSINESS OF WHICH IS TO HOLD INVESTMENTS AND THE ENTIRE SHARE CAPITAL OF WHICH IS OWNED BY ONE OR MORE INDIVIDUALS, EACH OF WHOM IS AN ACCREDITED INVESTOR; OR

(B) A TRUST (WHERE THE TRUSTEE IS NOT AN ACCREDITED INVESTOR) WHOSE SOLE PURPOSE IS TO HOLD INVESTMENTS AND EACH BENEFICIARY OF THE TRUST IS AN INDIVIDUAL WHO IS AN ACCREDITED INVESTOR,

SHARES, DEBENTURES AND UNITS OF SHARES AND DEBENTURES OF THAT CORPORATION OR THE BENEFICIARIES' RIGHTS AND INTEREST (HOWSOEVER DESCRIBED) IN THAT TRUST SHALL NOT BE TRANSFERRED WITHIN 6 MONTHS AFTER THAT CORPORATION OR THAT TRUST HAS ACQUIRED SUCH CLASS A SHARES PURSUANT TO AN OFFER MADE UNDER SECTION 275 EXCEPT:

(1) TO AN INSTITUTIONAL INVESTOR (FOR CORPORATIONS, UNDER SECTION 274 OF THE SFA) OR TO A RELEVANT PERSON DEFINED IN SECTION 275(2) OF THE SFA, OR TO ANY PERSON PURSUANT TO AN OFFER THAT IS MADE ON TERMS THAT SUCH SHARES, DEBENTURES AND UNITS OF SHARES AND DEBENTURES OF THAT CORPORATION OR SUCH RIGHTS AND INTEREST IN THAT TRUST ARE ACQUIRED AT A CONSIDERATION OF NOT LESS THAN S$200,000 (OR ITS EQUIVALENT IN A FOREIGN CURRENCY) FOR EACH TRANSACTION, WHETHER SUCH AMOUNT IS TO BE PAID FOR IN CASH OR BY EXCHANGE OF SECURITIES OR OTHER ASSETS, AND FURTHER FOR CORPORATIONS, IN ACCORDANCE WITH THE CONDITIONS SPECIFIED IN SECTION 275 OF THE SFA;

(2) WHERE NO CONSIDERATION IS OR WILL BE GIVEN FOR THE TRANSFER; OR

(3) WHERE THE TRANSFER IS BY OPERATION OF LAW.

As to the Common LP Units

THIS MEMORANDUM HAS NOT BEEN REGISTERED AS A PROSPECTUS WITH THE MONETARY AUTHORITY OF SINGAPORE AND THIS OFFERING IS NOT REGULATED BY ANY FINANCIAL SUPERVISORY AUTHORITY PURSUANT TO ANY LEGISLATION IN SINGAPORE. YOU SHOULD ACCORDINGLY CONSIDER CAREFULLY WHETHER THE INVESTMENT IS SUITABLE FOR YOU.

EACH INVESTOR AGREES THAT THIS MEMORANDUM AND ANY OTHER DOCUMENT OR MATERIAL IN CONNECTION WITH THE OFFER OR SALE, OR INVITATION FOR SUBSCRIPTION OR PURCHASE, OF COMMON LP UNITS MAY NOT BE CIRCULATED OR DISTRIBUTED, NOR MAY SUCH COMMON LP UNITS BE OFFERED OR SOLD, OR BE MADE THE SUBJECT OF AN INVITATION FOR SUBSCRIPTION OR PURCHASE, WHETHER DIRECTLY OR INDIRECTLY, TO PERSONS IN SINGAPORE OTHER THAN INSTITUTIONAL INVESTORS (AS DEFINED IN SECTION 4A OF THE SECURITIES AND FUTURES ACT, CHAPTER 289 OF SINGAPORE ("SFA")), ACCREDITED INVESTORS (AS DEFINED IN SECTION 4A OF THE SFA) OR ANY PERSON PURSUANT TO AN OFFER THAT IS MADE ON TERMS THAT SUCH COMMON LP UNITS ARE ACQUIRED AT A CONSIDERATION OF NOT LESS THAN S$200,000 (OR ITS EQUIVALENT IN A FOREIGN CURRENCY) FOR EACH TRANSACTION, WHETHER SUCH AMOUNT IS TO BE PAID FOR IN CASH OR BY EXCHANGE OF SECURITIES OR OTHER ASSETS.

NOTICE TO RESIDENTS OF SPAIN

NO PUBLIC OFFERING OF THE COMMON LP UNITS WILL BE CARRIED OUT IN THE SPANISH TERRITORY, PURSUANT TO THE DEFINITION OF PUBLIC OFFER CONTAINED IN ARTICLE 30 BIS OF THE SECURITIES MARKET LAW 24/1988, OF JULY 28. CONSEQUENTLY, THIS MEMORANDUM HAS NOT BEEN AND WILL NOT BE VERIFIED OR REGISTERED WITH THE SPANISH SECURITIES MARKET COMMISSION (COMISION NACIONAL DEL MERCADO DE VALORES, "CNMV").

NOTICE TO RESIDENTS OF SWITZERLAND

THE UNITS ARE BEING OFFERED BY WAY OF A PRIVATE PLACEMENT TO A LIMITED NUMBER OF INVESTORS WITHOUT ANY PUBLIC OFFERING IN OR FROM SWITZERLAND. THIS MEMORANDUM AND ANY OTHER OFFERING MATERIAL RELATING TO THE UNITS ARE INTENDED SOLELY FOR THE RECIPIENT; THE INFORMATION THEREIN IS STRICTLY CONFIDENTIAL AND THEREFORE MAY NOT BE DISTRIBUTED TO ANY THIRD PARTY OR THE PUBLIC IN GENERAL.

NOTICE TO RESIDENTS OF THE UNITED ARAB EMIRATES ("UAE")

BY RECEIVING THIS MEMORANDUM, THE PERSON OR ENTITY TO WHOM IT HAS BEEN ISSUED UNDERSTANDS, ACKNOWLEDGES AND AGREES THAT THIS MEMORANDUM HAS NOT BEEN APPROVED BY THE UAE CENTRAL BANK, THE UAE MINISTRY OF ECONOMY OR ANY OTHER AUTHORITY IN THE UAE, NOR ARE THE AGENTS AUTHORIZED OR LICENSED BY THE UAE CENTRAL BANK, THE UAE MINISTRY OF ECONOMY OR ANY OTHER AUTHORITY IN THE UAE TO MARKET OR SELL THE UNITS IN THE COMPANY WITHIN THE UAE. NO MARKETING OF ANY FINANCIAL PRODUCTS OR SERVICES HAVE BEEN OR WILL BE MADE FROM WITHIN THE UAE AND NO SUBSCRIPTION TO ANY SECURITIES, PRODUCTS OR FINANCIAL SERVICES MAY OR WILL BE CONSUMMATED WITHIN THE UAE.

THE AGENTS ARE NOT LICENSED BROKERS, DEALERS, FINANCIAL ADVISORS OR INVESTMENT ADVISORS UNDER THE LAWS APPLICABLE IN THE UAE, AND DO NOT ADVISE INDIVIDUALS RESIDENT IN THE UAE AS TO THE APPROPRIATENESS OF INVESTING IN OR PURCHASING OR SELLING SECURITIES OR OTHER FINANCIAL PRODUCTS. NOTHING CONTAINED IN THIS MEMORANDUM IS INTENDED TO CONSTITUTE INVESTMENT, LEGAL, TAX, ACCOUNTING OR OTHER PROFESSIONAL ADVICE IN, OR IN RESPECT OF, THE UAE.

THIS MEMORANDUM IS FOR YOUR INFORMATION ONLY AND NOTHING IN THIS MEMORANDUM IS INTENDED TO ENDORSE OR RECOMMEND A PARTICULAR COURSE OF ACTION. YOU SHOULD CONSULT WITH AN APPROPRIATE PROFESSIONAL FOR SPECIFIC ADVICE RENDERED ON THE BASIS OF YOUR SITUATION.

NOTICE TO RESIDENTS OF THE UNITED KINGDOM

THE COMPANY IS AN UNREGULATED COLLECTIVE INVESTMENT SCHEME FOR THE PURPOSES OF THE FINANCIAL SERVICES AND MARKETS ACT 2000 ("FSMA"), THE PROMOTION OF WHICH IN THE UNITED KINGDOM IS RESTRICTED BY THE FSMA. IF MADE BY A PERSON WHO IS NOT AN AUTHORISED PERSON UNDER FSMA, THE ISSUE OR DISTRIBUTION OF THIS DOCUMENT IN THE UNITED KINGDOM MAY ONLY BE MADE TO AND DIRECTED AT PERSONS WHO (I) ARE INVESTMENT PROFESSIONALS FALLING WITHIN ARTICLE 19 OF THE FINANCIAL SERVICES AND MARKETS ACT 2000 (FINANCIAL PROMOTION) ORDER 2005; OR (II) ARE PERSONS TO WHOM THE PROMOTION MAY OTHERWISE BE LAWFULLY MADE. IF MADE BY A PERSON WHO IS AN AUTHORISED PERSON UNDER FSMA, THE ISSUE OR DISTRIBUTION OF THIS DOCUMENT IN THE UNITED KINGDOM MAY ONLY BE MADE TO AND DIRECTED AT PERSONS WHO (I) ARE INVESTMENT PROFESSIONALS WITHIN ARTICLE 14 OF THE FINANCIAL SERVICES AND MARKETS ACT 2000 (PROMOTION OF COLLECTIVE INVESTMENT SCHEMES) (EXEMPTIONS) ORDER 2001; OR (II) ARE PERSONS TO WHOM THE PROMOTION MAY OTHERWISE BE LAWFULLY MADE. TRANSMISSION OF THIS DOCUMENT TO ANY OTHER PERSON IN THE UNITED KINGDOM IS UNAUTHORISED AND MAY CONTRAVENE THE FSMA. IN THE UNITED KINGDOM, PARTICIPATION IN THE COMPANY IS AVAILABLE ONLY TO SUCH PERSONS AND PERSONS OF ANY OTHER DESCRIPTION SHOULD NOT RELY ON THIS DOCUMENT.

NON-GAAP FINANCIAL MEASURES

EBITDA, Adjusted EBITDA and Adjusted EBITDAR (including pro forma presentations thereof) and the related ratios presented in this Memorandum are supplemental measures of our performance that are not required by, or presented in accordance with, generally accepted accounting principles in the U.S. ("GAAP"). EBITDA, Adjusted EBITDA and Adjusted EBITDAR are not measurements of our financial performance under GAAP and should not be considered as alternatives to net income, operating income or any other performance measures derived in accordance with GAAP, or as an alternative to cash flow from operating activities as a measure of our liquidity.

EBITDA represents net income before net interest expense, income tax expense, depreciation (including impairment charges) and amortization. Pro forma presentations of EBITDA have also added back KinderCare Learning Centers, Inc.'s ("KinderCare") discontinued operations, consistent with KLC's treatment of center closures and sales and KinderCare's historical presentation of EBITDA. Adjusted EBITDA represents EBITDA plus (i) expenses (minus gains) that we do not consider reflective of our ongoing operations after the KinderCare acquisition, as further described in this Memorandum and (ii) management fees which are subordinated to our obligations on our 7¾% senior subordinated notes (the "Notes") and which are added back in measuring our performance for purposes of our ability to incur debt under our indenture. Our actual and projected Adjusted EBITDA, where applicable, also exclude non-cash stock-based compensation expense, which is also excluded under our indenture; accruals under our stock appreciation rights ("SAR") plan; and accruals under our long term incentive plan, which are non-cash at the time of award and vest and become payable in three years subject to continued employment (with certain exceptions). Our pro forma Adjusted EBITDA for 2005 excludes restructuring and integration charges associated with the KinderCare acquisition and the cost of operating parallel organizations during the integration process, which management does not consider reflective of ongoing operations. Adjusted EBITDAR is Adjusted EBITDA plus rent expense. We present EBITDA, Adjusted EBITDA and Adjusted EBITDAR because we consider them to be important supplemental measures of our performance and believe they are frequently used by securities analysts, investors and other interested parties in the evaluation of issuers, many of which present EBITDA and/or Adjusted EBITDA and/or Adjusted EBITDAR when reporting their results.

We are basing our executive incentive compensation payments in part on our performance measured using Adjusted EBITDA including adjustments described herein. We also use financial measures similar to Adjusted EBITDA, though subject to certain different adjustments, in the senior credit facility that we entered into in connection with the KinderCare acquisition and the indenture governing the Notes to measure our compliance with covenants such as interest coverage and debt incurrence. Measures similar to Adjusted EBITDA are also widely used by us and others in our industry to evaluate and price potential acquisition candidates. For example, we evaluated the KinderCare acquisition and our 2003 acquisition of ARAMARK Educational Resources to a significant degree based on their historical and potential EBITDA, as adjusted for items we did not consider representative of post-acquisition operations. We believe EBITDA and Adjusted EBITDA facilitate operating performance comparisons from period to period and company to company by backing out potential differences caused by variations in capital structures (affecting relative interest expense), tax positions (such as the impact on periods or companies of changes in effective tax rates or net operating losses) and the age and book depreciation of facilities and equipment (affecting relative depreciation expense). We believe Adjusted EBITDAR is a useful measure of performance independent of occupancy costs.

We calculate Adjusted EBITDA by adjusting EBITDA to eliminate the impact of a number of items we do not consider indicative of our ongoing operations and for the other reasons noted above. For the reasons indicated herein, you are encouraged to evaluate each adjustment and whether you consider it appropriate. In addition, in evaluating Adjusted EBITDA and Adjusted EBITDAR, you should be aware that in the future we may incur expenses similar to the adjustments in the presentation of Adjusted EBITDA and Adjusted EBITDAR. Our presentation of Adjusted EBITDA and Adjusted EBITDAR should not be construed as an inference that our future results will be unaffected by unusual or non-recurring items.

EBITDA, Adjusted EBITDA and Adjusted EBITDAR have limitations as analytical tools, and you should not consider them in isolation, or as a substitute for analysis of our results as reported under GAAP. Some of these limitations are:

- they do not reflect our cash expenditures for capital expenditures or contractual commitments;
- they do not reflect the cost of our non-cash stock-based compensation or our SAR plan or long term incentive plan or the expense associated with allocating Profits Participation LP Units (as defined below) to employees;
- they do not reflect changes in, or cash requirements for, our working capital;
- they do not reflect the significant interest expense, or the cash requirements necessary to service interest or principal payments, on our indebtedness;
- they do not reflect management fees;
- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and our non-GAAP measures do not reflect cash requirements for such replacements or the related expense;
- they do not reflect the impact of earnings or charges resulting from the significant costs we have incurred in integrating KinderCare, and we are likely to incur significant integration costs in future acquisitions;
- other companies, including other companies in our industry, may calculate these measures differently than we do, limiting their usefulness as a comparative measure; and
- they do not comply with the requirements of Item 10(e) of Regulation S-K or Regulation G of the Securities and Exchange Commission ("SEC").

Because of these limitations, EBITDA, Adjusted EBITDA and Adjusted EBITDAR should not be considered as measures of discretionary cash available to us to invest in the growth of our business or reduce our indebtedness. We compensate for these limitations by relying on our GAAP results as well as these non-GAAP measures.

For more information, see our consolidated financial statements and the notes to those statements included elsewhere in this Memorandum.

FORWARD-LOOKING STATEMENTS

This Memorandum contains forward-looking statements, which involve risks and uncertainties. You can identify forward-looking statements because they contain words such as "anticipates," "expects," "should," 'intends," "plans," "believes," "seeks," "estimates," "will," "may," "approximately" and similar expressions which concern, among other things, the Company's results of operations, financial condition, liquidity, prospects, growth, strategies and the industry in which the Company operates. Examples include statements regarding anticipated growth in revenue, net income and EBITDA, expectations regarding the likelihood of recurrence of certain charges and gains, expectations regarding capital investments, and expectations regarding future cash generated from operations. These forward-looking statements are based on our management's current expectations, assumptions, estimates and projections about us and our industry. You are cautioned that actual results could differ from those anticipated by the forward-looking statements. Investors are cautioned not to place undue reliance on the projections contained in this Memorandum or other models and forecasts they may receive or discuss in connection with this offering.

Important factors that could cause our actual results, performance or achievements to be materially different from any future results, performance or achievements expressed or implied by those statements include, but are not limited to, those discussed under "Risk Factors," elsewhere in this Memorandum. The following list represents some, but not necessarily all, of the factors that could cause actual results to differ from historical results or those anticipated or predicted by any forward-looking statements:

- we may be unable to identify, consummate or obtain favorable terms on acquisitions of businesses or interests therein, which is a principal component of our growth strategy;
- our international expansion strategy is untested, and our acquisition and development of non-U.S. businesses may not be successful;
- the loss of any of our key management employees could adversely affect our business;
- we have a substantial level of indebtedness and plan to incur additional debt;
- we face intense competition in the early childhood care and education services industry from numerous other types of providers;
- we may acquire companies that are not well-established or experiencing financial difficulties;
- we rely on the management teams of our subsidiaries, who may not be able to operate them in accordance with our plans;
- we may acquire minority interests in various companies (such as *k*12 Inc. ("*k*12")) and we may not be able to protect our interests adequately in respect of such investments;
- we or our subsidiaries may be unable to raise additional financing which may be needed to satisfy certain of our subsidiaries' working capital requirements;
- failure to comply with present or future applicable U.S. or foreign governmental regulation and licensing requirements could have a material adverse effect on our operations;
- activities of Knowledge Universe Learning Group LLC ("KULG"), the parent entity of the General Partner and/or its Principals may be competitive with the Company; conflicts of interest may arise with the Principals and their affiliates; the Company may not engage in certain businesses;
- litigation and adverse publicity concerning incidents at child care centers could hurt our reputation;
- our insurance policies may prove inadequate to cover claims, and we may be unable to maintain our existing coverage in the future at reasonable prices;
- factors beyond our control, such as economic conditions, could affect demand for our child care services;

- a loss or reduction of government funding for child care assistance programs or food reimbursement programs could adversely affect us;

- a termination or reduction of tax credits for child care could have a material adverse effect on our business;

- if we (or our subsidiaries) are unable to attract and retain sufficient qualified employees, if minimum wage rates increase or if our employees (or our subsidiaries' employees) unionize, our results of operations may be adversely affected;

- our results of operations could be adversely affected if environmental contamination is discovered on any of our properties; and

- material weaknesses in KLC's internal controls discovered during KLC's fiscal year 2005 audit.

BACKGROUND DATA

Industry and market data used throughout this Memorandum is based on independent industry publications, government publications, reports by market research firms and other published independent sources. Some data is also based on our good faith estimates, which are derived from our review of internal surveys and independent sources. Such information necessarily incorporates significant assumptions as to factual or other matters. Although we believe these sources are reliable, we have not independently verified the information from third party-sources or the assumptions on which such information is based and cannot guarantee its accuracy or completeness. Some of the industry data contained in this Memorandum has not been updated because we have been unable to obtain more recent data. Although we are not aware of trends contrary to those reflected in such data (except as otherwise stated), we cannot assure you that such data are indicative of current trends.

TRADEMARKS

The intellectual property portfolio of the Company includes registered and unregistered trademarks and service marks and collective trademarks that distinguish the services and products that it offers from those services and products offered by other companies.

In addition, the Company has applied to register certain other trademarks, service marks and collective trademarks in the U.S. and other countries, and likely will seek to register additional marks in the future. A federal registration in the U.S. is effective for ten years and may be renewed for ten-year periods perpetually, subject only to required filings based on continued use of the mark by a registrant. It is possible that some of these applications to register additional marks will not result in registrations.

KLC's primary trademarks are "Knowledge Learning Corporation," "Children's World," "Knowledge Beginnings," "Children's Discovery Centers" and "Medallion School Partnerships."

KinderCare owns and uses various registered and unregistered trademarks and service marks covering the name "KinderCare," its schoolhouse logo and a number of other names, slogans and designs, including "KinderCare at Work" and "Mulberry."

*k*12's primary trademarks are the *k*12 star logo, the word mark and design, which are licensed from an entity controlled by the Principals.

All other product and company names referred to in this Memorandum are trademarks and registered trademarks of their respective companies.

1. EXECUTIVE SUMMARY

The following summary is qualified in its entirety by the more detailed information appearing elsewhere in this Memorandum. You should carefully consider the information set forth under "Risk Factors". The term ""KUE" refers only to Knowledge Universe Education L.P., a Cayman Islands exempted limited partnership. The terms "Knowledge Universe Education", the "Company", "we", "us" and "our" refer to KUE and, where applicable, its subsidiaries, and do not refer to the Agents. In November 2005, KLC separated its education operations ("KLC OpCo") from its real estate assets ("KLC PropCo").

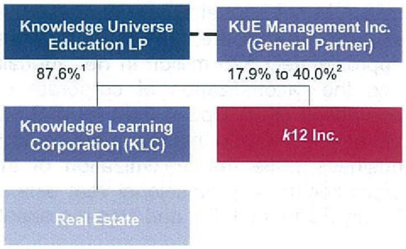
1.1. Company Overview

KUE is the third largest for-profit education company in the world and the largest for-profit education company in the pre-school to 12th grade segment ("pre-K-12") in the world. While the Company's operations are currently based within the U.S., the proceeds from this transaction will be used primarily to expand KUE's education platform both globally and across the pre-K-12 education continuum. KUE's existing portfolio of assets consists of:

(i) KLC OpCo, the leading early childhood education ("ECE") company with 2,507 locations in 39 states and the District of Columbia and nearly two and a half times larger than its next closest competitor in terms of revenue;

(ii) KLC PropCo, one of the largest education based real estate portfolios in the U.S. consisting of 845 early childhood centers located in 37 states; and

(iii) A significant interest in *k*12, an online curriculum provider and kindergarten through 12th grade management company, currently serving over 25,000 students as the largest operator of online virtual schools in the U.S.


Knowledge Universe Education LP
KUE Management Inc. (General Partner)
87.6%[1]
17.9% to 40.0%[2]
Knowledge Learning Corporation (KLC)
k12 Inc.
Real Estate

The principal owners of KUE are Michael Milken, Lowell Milken and Steven Green (collectively the "Principals"). Michael Milken and Lowell Milken each has more than two decades of experience in the education sector through involvement in several for-profit and not-for-profit initiatives. Steven Green, former U.S. ambassador to Singapore, has more than two decades of experience as an international industrialist leading major corporate restructurings and expansions in manufacturing, housing, consumer products, retail and real estate enterprises. The Company represents the Principals' sole vehicle for equity investment opportunities in the pre-K-12 sector going forward.

The Principals founded the Company and its affiliated companies over the past decade based on their vision of a world where competition for human capital[3] is becoming the driving force of economic prosperity. To remain competitive in the world economy, countries will be forced to invest heavily in the development of their human capital. The Principals believe that an investment made in an individual's education, especially at a young age, is the most effective way to build human capital and thereby increase that individual's lifelong productivity. As the largest for-profit provider of ECE in the world, the Company is well positioned to capitalize on these trends.

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[1] *The 12.4% minority position is held by various investors.*

[2] *KUE's ownership varies depending on the liquidation value or sale value of k12 and according to the preference of the various securities KUE owns. At higher valuations, KUE's percentage ownership is lower. See "k12 Inc. (k12) – k12 Equity."*

[3] *The economic theory of Human Capital Policy was first published by University of Chicago professor James Heckman in Human Capital Policy, dated August 2002.*

Education is one of the largest sectors in the world, representing approximately 5% of global gross national income of $48 trillion.[4] In 2005 in the U.S. alone, education was a $1 trillion market.[5] Education is still predominantly provided by public / governmental entities in most countries including the U.S. KUE believes that the industry will converge towards a more balanced public / private system, similar to the evolution observed in the 20th century in other major industries such as healthcare, infrastructure and telecommunications.

The Company's strategy is to grow its existing platforms both domestically and internationally and to expand its assets globally across the pre-K-12 education continuum. In addition to its current investments in ECE and online curriculum, KUE will seek to expand by acquiring education companies offering services or products that can complement its current offering. KUE believes that owning a diversified portfolio of assets in the pre-K-12 education space will allow it to leverage content and best practices across multiple constituencies and to multiple markets. KUE's strategy in U.S. ECE is to expand its existing platform through the opening of new centers, opportunistic acquisitions of smaller competitors and the sale of education-related products and services through existing channels. Internationally, KUE has identified several near-term opportunities to expand into Europe, the Middle-East and Asia, with some of these opportunities in advanced stages of preparation.

Management has a history of successfully growing through acquisitions. In May 2003, KLC acquired Aramark Educational Resources ("AER"), a company three times its size in terms of revenue. Management completed the integration of AER in approximately 12 months, realizing approximately $10 million in net annual synergies and improving operational performance. In January 2005, the Company acquired KinderCare, the largest provider of ECE services in the U.S. at the time. Management achieved approximately $25 million in net annualized synergies through the closing of under-performing centers and the rationalization of corporate overhead. In November 2005, KLC separated its education operations (KLC OpCo) from its real estate assets (KLC PropCo). Management believes this division allows KLC OpCo management to focus on the core business of operating and growing the ECE business while the maximization of the valuable educational real estate portfolio is managed and expanded by a professional real estate firm, Greenstreet Real Estate Partners (formerly Greenstreet Realty Partners, L.P.), and also represents management's view of KLC's component businesses.

Management believes that KUE presents an attractive financial profile with its combination of businesses: (i) KLC OpCo, which generated $1.48 billion in pro forma revenue and $150 million in pro forma Adjusted EBITDA[6] in 2005, is projected to grow organically to $2.3 billion and $320 million by 2011, respectively and to generate operating cash flow growing from $72 million in 2005 to $214 million in 2011; (ii) a real estate portfolio in KLC PropCo that generated an additional $88 million in pro forma EBITDA in 2005; and (iii) an investment in *k*12, which continues to deliver top line growth in excess of 25% and has seen its revenue grow at a 133% compounded annual growth rate over the last three fiscal years (from $6.7 million in 2002 to $85.1 million in 2005).

1.2. Investment Rationale

1.2.1 Attractive Industry Characteristics

- **The global for-profit education market is large and growing**

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[4] *Source: UNESCO Institute for Statistics database.*

[5] *Source: US Department of Education National Center for Education Statistics and Training Magazine and Harris Nesbitt research.*

[6] *Pro forma for the acquisition of KinderCare and the separation of KLC into KLC OpCo and KLC PropCo.*

Education is one of the largest sectors in the world and represents a large portion of a country's investments

- — Represents approximately 5% of global gross national income of $48 trillion. In the U.S. alone, education represents a $1 trillion market with for-profit education accounting for approximately $81 billion or 7.8% of the overall market.
- — The pre-K-12 segment of the education market is approximately a $610 billion market, with for-profit pre-K-12 education accounting for approximately $37.4 billion, over 6.1% of the pre-K-12 market.[7]

The for-profit education sector is growing at an attractive rate

- — U.S. education spending has grown at a stable compound annual growth rate ("CAGR") of 5.7% since 1993. The for-profit component of this industry (pre-K-12, post secondary and corporate training) is projected to grow faster than the overall historical industry growth rate, at a 7.4% annual rate, reflecting the increasing importance of for-profit operations in the sector, to reach a market size of $116 billion by 2010.[7]
- — In addition, these estimates do not reflect the growing segment of direct to consumer educational materials such as supplemental tutoring, which represented an estimated $20 billion of additional spending in 2004.

■ **Increasing competition for human capital**

To remain competitive in the global economy, countries are investing heavily in the development of their human capital, especially at young ages

- — According to the World Bank's World Education Indicators, worldwide enrollment rates in pre-primary education increased by 37% from 1995 to 2003.[8]
- — KUE believes that education companies will become significantly more valuable as countries become increasingly aware of the competitive advantages afforded by education. Of the top 100 global companies by market cap, not a single education company is represented on the list.

As globalization of the economy and improving technologies flatten the playing field, demand for more standardized education across regions increases

- — KUE believes that increasingly global education standards, enhanced workforce mobility and new technologies are catalysts of world competition for human capital.

■ **Several international growth opportunities**

The Company is starting to execute on its international development strategy

- — In the near term, the Company is focusing on opportunities identified in the United Kingdom, Saudi Arabia, the United Arab Emirates and China. Depending on the state and organization of each country's education sector, KUE's development will be executed through cooperation with government authorities, outright acquisitions and/or the establishment of partnerships with key local players.

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[7] *Source: Harris Nesbitt, Education and Training, September 2005.*
[8] *Source: Education Trends in Perspective: Analysis of the World Education Indicators, 2005.*

- These initiatives could provide three key regional platforms for further development and consolidation.

In the medium term, numerous opportunities for KUE should be generated by the increasing demand for quality for-profit educational offerings by governments and citizens around the world

- Competitive pressures for development of human capital, deficiencies of national education systems, growth of a middle-class in China, India and the Middle East, demand for English language offerings and changing demographics are some of the primary drivers of increased demand internationally.
- In China alone, 274 million children are under the age of 15, and 100 million are single-children under the age of 25, as a result of the one-child policy. These demographics result in large demand for education and increased spending capacity per child.

■ **Favorable demographic trends and customer behavior in the U.S.**

Growing number of working mothers

- According to the Bureau of Labor Statistics (BLS) estimates, women are expected to represent nearly 48% of the total U.S. workforce by 2012, up from 46.6% in 2002.[9]
- In the U.S., approximately 60% of mothers with children under the age of six are employed.

Increasing birth rate

- There are approximately 24 million children under the age of five in the U.S. today. According to the U.S. Census Bureau, absolute birth rates are going to continue to increase, and the population of children in the U.S. five and under is expected to increase to approximately 27 million by 2015.[10]

Essential nature of the service to the consumer

- As with healthcare, parents are primarily focused on the quality of the service that their child receives and the proximity of the center to their home or work; price is typically a secondary consideration. By relieving parents of the requirement to stay at home with their children, ECE allows both men and women to participate in the workforce and generate income for the household.

1.2.2 Compelling Business Profile

■ **KUE presents an attractive financial profile**

For the fiscal year ended December 31, 2005, KLC OpCo had operations in 39 states and Washington D.C. and generated pro forma revenue of $1.48 billion

- With organic growth projected to be in excess of 5% per annum through 2011, geographic diversity and double-digit Adjusted EBITDA margins, KLC OpCo can generate attractive returns.
- KLC OpCo generates strong operating cash flow (48% of 2005 pro forma Adjusted EBITDA) which provides significant resources to fund investment and support equity return-enhancing leverage, a

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[9] *Source: Harris Nesbitt, Education and Training, September 2005.*

[10] *Source: Population Projections Branch, U.S. Census Bureau, "U.S. Interim Projections by Age, Sex, Race and Hispanic Origin," May 2004.*

KLC OpCo has leveraged its scale and operational expertise to roll out a proprietary curriculum and to provide enhanced corporate level services

- — Curriculum has been developed, rolled out and refined over many years and provides a significant competitive advantage in an industry where small independent players do not have the resources to develop comparable programs.
- — Operational leverage allows for enhanced marketing, back-office, legal and compliance functions, keeping KLC OpCo at the forefront of education standards.

Controls that meet or exceed requirements established by licensing authorities, state and federal government and accrediting bodies

- — Controls include rigorous and stringent hiring procedures and uniform rules for conduct.
- — 43% of KLC OpCo's centers, over four times the industry average of 10%, are accredited by the National Association for the Education of Young Children (referred to herein as "NAEYC"), the nation's leading accreditation body. Management believes that all the Company's centers' operations and policies meet or are substantially compliant with NAEYC accreditation requirements.

- ■ **A compelling business model at *k*12**

As the state of education across the U.S. is generating increasing concerns, *k*12 provides a compelling value proposition

- — Children continue to perform poorly on assessment tests geared to measure reading, writing and math skills. The passing of legislation such as the "No Child Left Behind Act of 2001" which, among other things, provides for increased funding for education and implementation of achievement level standards, demonstrates the commitment of government to address the issue.

Technology and content platform easily leverageable to provide results-driven curriculum and service

- — With $70 million invested in the development of the platform for kindergarten to 9th grade classes, extension of the offering into new states and schools is expected to be achieved at relatively low costs.
- — *k*12 benefits from stable demand for its curriculum and services which is reflected by current reenrollment rates of 65% to 70%.
- — Many of the direct costs are semi-fixed in nature (*e.g.*, school administration) creating strong economies of scale as this business continues to grow.

- ■ **Valuable real estate portfolio of centers providing solid asset base**

845 owned centers recently appraised at approximately $1.25 billion[12]

- — New organization separating management of real estate assets allows KLC OpCo education teams to focus on the core education business.
- — Long term partnership with Greenstreet Real Estate Partners ensuring state-of-the-art management of the real estate assets by a leader in this field.

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[12] *Actual appraisal was for 713 out of 845 centers and the appraised value was $1.1 billion. The $1.25 billion is achieved by taking the independent appraisal valuation methodology and extrapolating it to the remaining 132 centers.*

- **Strong leadership teams**

KUE

- Strong team of highly experienced professionals at the KUE level, led by CEO Lowell Milken, Chairman Michael Milken and Vice-Chairmen Steven Green and Ted Sanders. The team contributes an average of more than two decades of experience in their respective fields to KUE.
- Providing corporate headquarters support services in the areas of strategy and business development, acquisitions, recruiting of executives, communication and government relations.

KLC OpCo

- Highly experienced management team comprised of both experts in the field of education (COO Dr. Elanna Yalow has substantial experience operating for-profit ECE centers), as well as business professionals.
- Seasoned executive and middle management team with average Company tenure of ten years.

*k*12

- Chairman, Founder and acting CEO Ron Packard has extensive experience in the K-12 education space and was previously with KLC before founding *k*12. John Baule, Executive Vice President and CFO, served as CFO of Headstrong for five years before joining *k*12.

1.2.3 Value Creating Strategy

- **Value is created by owning assets across the pre-K-12 education continuum**

Incremental value is expected to be created from strategic and financial synergies inherent in a global platform

- The Company can exploit the similarities in various education markets by capitalizing on the assets it owns (*e.g.*, using KLC's expertise to establish similar operations across geographies and across the pre-K-12 education continuum).
- Sharing of best practices globally and ability to cross-sell products and services to the Company's customers.
- Entry into less structured international markets early in their development cycle to establish attractive competitive positions.

- **Multiple growth opportunities at KLC and *k*12**

Top line organic growth at KLC OpCo is expected to be driven by several factors:

- Historically the industry has demonstrated a pattern of price increases above inflation. Historical industry data shows an average tuition rate increase of 7% per annum.[13]
- Higher "Utilization"[14] resulting from increased student enrollment, improved retention rates, further network rationalization to better align supply with demand, more favorable center build rate in the broader industry and favorable macro trends.

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[13] *Source: The National Economic Impacts of the Child Care Sector 2002.*

- The ECE industry generates approximately $54 billion in total spending in the U.S. and has grown at a compound annual growth rate of 10% since 1982. It is expected to grow at a 3.4% compounded annual rate through 2010 according to Harris Nesbitt research. The ECE industry's growth has been driven by several favorable social and demographic trends including: the increase in working mothers and single-parent or dual-income families, historically high birth rates, and increase in popularity of center-based care.

- Net opening of new centers as the integration of KinderCare winds down and the number of center openings starts exceeding the number of closures.

- Leverage of KLC OpCo's footprint to market additional educational products and services to the more than 300,000 children KLC OpCo interacts with each year, their parents, grandparents and other child care providers. Selected incremental revenue opportunities include: foreign language or music lessons, educational materials and financial services (life insurance, health insurance, tuition financing, etc.).

Growth through acquisitions and industry consolidation

- Consolidation strategy supported by the highly fragmented early childhood industry, with for-profit chains representing only approximately 5% of the market in aggregate, and small independent providers representing 60% of the market.[15]

- Management has demonstrated an ability to grow through acquisitions, as evidenced by the three networks acquired by KLC since inception, of sizes up to 1,000 centers.

Multiple drivers of expected double-digit growth at *k*12

- Existing school enrollment rates at *k*12 expected to continue to increase at double digit rates for at least the next three years, as *k*12 further penetrates its existing markets through commercial and marketing push.
- *k*12 currently operates virtual public schools in 11 states and the District of Columbia. As legislatures in other states permit the formation of virtual public schools, *k*12 expects to have opportunities to expand into new states.

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[14] *Utilization is calculated as the total actual child care revenues earned at centers that are open at the calculation date divided by the total potential child care revenue (based upon the center's undiscounted pre-school tuition rate and the center's total licensed capacity) during the related time period.*

[15] *Source: Harris Nesbitt, Education and Training, September 2005.*

2. SUMMARY TERMS OF THE TRANSACTION

Certain of the key terms of the offering, which are subject to and qualified in their entirety by reference to the Limited Partnership Agreement of KUE, the organizational documents of the General Partner and applicable Cayman Islands law, are outlined below. The terms summarized herein are set forth in detail in the Limited Partnership Agreement of KUE, the Agreement Among Members of KUE Management, Inc. and the Amended and Restated Memorandum and Articles of Association of KUE Management, Inc., copies of which have been provided or are available upon request. Such summaries are qualified in their entirety by reference to such agreements.

Issuers:	Knowledge Universe Education L.P., a Cayman Islands exempted limited partnership ("KUE") and KUE Management Inc., a Cayman Islands exempted company, the general partner of KUE (the "General Partner").
Securities Offered:	Up to 1,000,000 investment units (the "Units"), each comprised of one Common Limited Partner Unit ("Common LP Unit") in KUE and one Class A ordinary share ("Class A Share") of the General Partner at an offering price of U.S. $1,000 per Unit ($999 allocated to the Common LP Unit and $1 allocated to the Class A Share) (the "Purchase Price") for aggregate proceeds of U.S. $1 billion (subject to increase in the offering size by the General Partner at its sole discretion up to an aggregate of 1,500,000 Units to Investors, with aggregate proceeds of U.S. $1.5 billion). The offering is expected to be completed in one or more closings on or before March 31, 2007 (the "Offering Period"). Since the General Partner will have a nominal economic interest in KUE, the Class A Shares are expected to have nominal economic value. The Class A Shares are, however, intended to provide Unit holders with certain voting and other governance rights in the General Partner (as described further below) which, in turn, will control KUE. The Common LP Units and the Class A Shares comprising the Units owned by the investors (the "Investors") will not be separately transferable unless otherwise approved by the Board of Directors of the General Partner and a committee of Independent Directors (as defined below) (the "Independent Committee").
Minimum and Maximum Investment:	U.S. $25 million (subject to waiver by the General Partner at its sole discretion). At any closing after the first closing of the offering of the Units, the maximum investment permitted will be U.S. $185.0 million.
Closing:	KUE may accept or reject subscriptions, in whole or in part, at its sole discretion. KUE will hold one or more closings in connection with the sale of the Units on dates specified by KUE to the Investors. The minimum amount of subscriptions to be accepted in the first closing of the offering (including the amount attributable to Knowledge Universe Education

	LLC, a Delaware limited liability company ("KUE LLC") through conversion of its preferred limited partner units, including accrued dividends at the option of KUE LLC, into Common LP Units) is U.S. $280.0 million. Subscriptions received will be promptly refunded if 280,000 Common LP Units are not issued for $1,000 per unit (in cash or preferred limited partner units) before the end of the Offering Period. Subscriptions paid in any closing will not otherwise be returned regardless of the size or occurrence of any subsequent closing. Investors admitted during the Offering Period after the first closing of this offering and after September 30, 2006 will pay an additional amount accruing at a rate of 0.67% per month calculated from the first closing date of the offering (pro-rated for partial periods) for each Common LP Unit purchased, which will be distributed promptly to the holders of Common LP Units outstanding prior to such admission in proportion to the number of Common LP Units held by such holders.
Use of Proceeds:	The proceeds of the offering described herein will be used: (i) to expand operations, including through strategic acquisitions in the U.S. and internationally, (ii) to develop new products and services, (iii) to repay, in whole or in part, $150 million of existing debt plus accrued interest (including through the application of a portion of the proceeds of the initial closing of the offering), (iv) an estimated $50 million in fees and expenses (including amounts payable from July 1, 2006 under a Fixed Overhead Payment Agreement (the "Fixed Overhead Payment Agreement")), (v) in the discretion of KUE LLC, payment at the initial closing of the offering of approximately $7.0 million of accrued preferred return on the preferred limited partner units of KUE being converted to Common LP Units if such accrued preferred return is not converted to Common LP Units and (vi) for other corporate purposes.
Capital Structure:	Assuming that 1,000,000 Units are sold to Investors by March 31, 2007, and that the accrued dividends on the preferred limited partner units are paid in cash, approximately 2,530,000 Units will be outstanding. The Investors will own approximately 40% of KUE in the form of Common LP Units (excluding profits participation limited partner units of KUE, "Profits Participation LP Units") and approximately 40% of the General Partner in the form of Class A Shares. The General Partner will be the sole general partner of KUE and will hold approximately 1,000 General Partner Units ("GP Units") in KUE, representing approximately 0.04% ownership in KUE. The economic interest in KUE represented by the Common

LP Units and the GP Units will be reduced by the Profits Participation LP Units as described below under "Distributions."

Assuming that 1,000,000 Units are sold to Investors by March 31, 2007, and that the accrued dividends on the preferred limited partner units are paid in cash, KUE LLC, controlled by the Principals, will hold approximately 1,530,000 Common LP Units representing approximately 60% ownership in KUE (excluding Profits Participation LP Units) and 1,530,000 Class A Shares. The Common LP Units owned by KUE LLC will not be transferable, except to (i) the Principals; (ii) to affiliates of the Principals; and/or (iii) to family members and/or charitable organizations in connection with the Principals' estate planning, unless combined with the corresponding percentage of Class A Shares to form Units and transferred in the form of Units in accordance with the Limited Partnership Agreement.

Knowledge Universe Holdings LLC, a Delaware limited liability company ("KUH LLC") controlled by the Principals, will hold 900 Class B ordinary shares of the General Partner (the "Class B Shares"). The Class B Shares held by the Principals and their affiliates will not be transferable, except to (i) the Principals; (ii) to the affiliates of the Principals; and/or (iii) to family members and/or charitable organizations in connection with the Principals' estate planning. The Class B Shares will automatically convert to Class A Shares if the Principals' aggregate direct and indirect economic interest in KUE is less than 15% of the outstanding Partnership Units (as defined below) of KUE.

A limited liability company ("KULG LLC-1"), of which Knowledge Universe Learning Group LLC, a Delaware limited liability company that is controlled by the Principals ("KULG"), and certain other persons designated by KULG are members, will be the holder of the Profits Participation LP Units (the "Profits Participation Limited Partner") with the economic rights as set forth in "– Distributions" below. At each closing of any sale of Units to Investors where the aggregate purchase price of all Units acquired by Investors to date is less than or equal to $1.5 billion (during the Offering Period or thereafter), the Profits Participation Limited Partner will be issued a number of Profits Participation LP Units such that the aggregate shall equal at least 9/11ths of the 11% of "Partnership Units" (Common LP Units, GP Units, and Profits Participation LP Units) that may be represented by Profits Participation LP Units. Additional Profits Participation LP Units will be issued to the Profits Participation Limited Partner, at such time and in such numbers as the Profits Participation Limited Partner will direct, based upon the issuance by the Profit Participation Limited Partner of interests to members of the Profits Participation Limited Partner (who may include employees, officers, directors, consultants and agents of KUE, its

	subsidiaries and joint ventures as designated by KULG other than the Principals and their affiliates), the vesting schedule of such interests, and whether certain tax elections are made by the recipients of such interests; provided, however, the total number of Profits Participation LP Units shall not exceed a number equal to eleven percent (11%) of the aggregate number of Partnership Units. Any increase in the number of Profits Participation LP Units following the sale of the first $1.5 billion of Common LP Units to Investors requires a majority vote of the Independent Committee. Subsequent to the completion of this offering, KUE may raise additional capital through the sale of equity or debt securities. KUE will not have any preferred limited partner units outstanding upon completion of this offering but KUE may issue limited partner units with preferences over the Common LP Units in the future and may amend the Limited Partnership Agreement accordingly.
Distributions:	First, to the Common Limited Partners and the General Partner in proportion to and to the extent of their unreturned Capital Contributions, but in no case may a distribution pursuant to this paragraph exceed a Partner's positive adjusted capital account balance; Second, to the Common Limited Partners and the General Partner and the Profits Participation Limited Partner (with respect to Profits Participation Units theretofore allocated to persons other than the Principals and their Affiliates, if specified by the Profits Participation Limited Partner, but not with respect to more than 2/11ths of the Profits Participation Units) to the extent of an 8% preferred return; Third, to the Profits Participation Limited Partner in the additional amount the Profits Participation Limited Partner would have received pursuant to the prior paragraph if it had fully participated in the distribution of the 8% preferred return with respect to all outstanding Profits Participation Units; and Fourth, to the Common Limited Partners, the Profits Participation Limited Partner, and the General Partner in proportion to the number of Units held by each such Partner. Distributions may be made in cash or in kind. Allocations of income, gains, profits and losses are described in "The Structure of KUE and the General Partner" in this Private Placement Memorandum. The Limited Partnership Agreement gives the General Partner the authority to override the distribution provisions of the Limited Partnership Agreement described above in order to achieve the desired economic arrangement of KUE, which is: (i) first, to return the Partners' Capital Contributions to them; (ii) second, for the Common Limited Partners and the General Partner to receive their Preferred Return while the

	Profits Participation Limited Partner concurrently receives an amount equal to a fraction of the amount the Common Limited Partners and the General Partner received pursuant to their Preferred Return (such fraction to be equal to the portion of the Units held by the Profits Participation Limited Partner attributable to members of the Profits Participation Limited Partner other than the Principals), multiplied by the number of Units held by the Profits Participation Limited Partner divided by the number of outstanding Units other than those Units held by the Profits Participation Limited Partner; (iii) third, for the Profits Participation Limited Partner to receive an amount equal to a fraction of the amount the Common Limited Partners and the General Partner received pursuant to their Preferred Return (such fraction to be equal to the portion of the Units held by the Profits Participation Limited Partner attributable to members of the Profits Participation Limited Partner who are Principals or their affiliates), multiplied by the number of Units held by the Profits Participation Limited Partner divided by the number of outstanding Units other than those Units held by the Profits Participation Limited Partner; and (iv) finally, for all Partners (including the Profits Participation Limited Partner) to share in the profits of the Partnership in proportion to the number of Units held by them. Notwithstanding any contrary provisions below addressing equal merger consideration, in connection with any distribution of securities of a subsidiary entity which has high vote and low vote (or non-voting) securities with substantially equivalent economic rights, the Principals can receive the high-vote securities in such a distribution while the other holders of Common LP Units receive the low vote (or non-voting) securities, as long as the securities otherwise have substantially equivalent economic rights and the high-vote securities have mandatory conversion features equivalent to the mandatory conversion provision of the Class B Shares.
Equal Merger Consideration Provision:	The Principals (through KUE LLC) and the Investors will receive the same consideration per Common LP Unit and/or Class A/Class B Shares in connection with a sale, merger, recapitalization, share repurchase, dividend, or any other transaction where all holders of Common LP Units or shares in the General Partner receive consideration with respect to their Common LP Units or shares, other than with respect to corporate restructuring transactions, such as a holding company merger, conversion of KUE from an exempted limited partnership to a corporation or other entity, change of domicile, or any other transaction that the Independent Committee determines is a "corporate restructuring." In any such corporate restructuring transaction, the Principals (through KUE LLC) may receive securities with high-voting rights and the Investors may receive securities with limited or no voting rights so long as the consideration received by the Principals (through KUE LLC) and the other Partners per

	Common LP Unit have substantially equivalent economic provisions.
Fixed Overhead Payment:	KUE and/or one or more of its subsidiaries will pay $20 million annually to KULG in quarterly installments beginning July 1, 2006 pursuant to the Fixed Overhead Payment Agreement as an agreed upon payment to provide for the reimbursement of expenses and other costs incurred by KULG on behalf of KUE and its subsidiaries (including, but not limited to, salaries and bonuses of KULG employees providing services to KUE and its subsidiaries, fees and expenses relating to financing transactions and acquisitions, professional fees and other administrative expenses). To the extent that the U.S. $2,500,000 fee payable pursuant to an existing management services agreement with Knowledge Learning Corporation is paid to any person or entity other than a subsidiary of KUE, the amount payable to KULG by KUE will be reduced by the amount of such payment to such other person or entity. The $20 million annual fee will terminate upon the Initial Listing (as defined below) or the sale of KUE to a person or entity that is not a KUE LLC Entity.
Voting Rights:	The General Partner will manage and operate KUE. The Investors will have no voting rights on matters affecting Company business with respect to their Common LP Units in KUE because the Investors will be limited partners of KUE. Notwithstanding the foregoing, subject to certain exceptions, KUE must obtain the consent of (a) the holders of a majority of the Common LP Units unaffiliated with the Principals to amend the Limited Partnership Agreement in a manner that is adverse to the Common LP holders and (b) the holders of at least 90% of the Common LP Units unaffiliated with the Principals to amend the "Equal Merger Consideration Provision" described above. In addition, the General Partner may not take any action to (a) alter or add to its Articles or (b) alter or add to its Memorandum with respect to any objects, powers or other matters specified therein that would adversely affect the rights of holders of Class A Shares without the affirmative vote of the holders of a majority of the Class A Shares. Holders of the Class A Shares of the General Partner will have one vote per share. The holders of Class B Shares, will have in the aggregate one more vote than the requisite legal vote required to approve particular matters. In addition, the Investors will have the right to elect directors to the Board of Directors of the General Partner as set forth in "Board of Directors" below. The Class B Shares will automatically convert to Class A Shares if the Principals' aggregate direct and indirect economic interest in KUE is less than 15% of the

	outstanding Partnership Units of KUE.
Board of Directors:	The General Partner will have a Board of Directors initially consisting of up to 13 persons. Following the first closing of the offering and prior to the "Initial Listing" (as defined below), the outside Investor (including its affiliates) holding the greatest number of shares in the General Partner at the first closing of the offering will appoint two directors of the General Partner and the holders of the Class B Shares will appoint the remaining directors. Following the initial appointment of the Board, the Board may, in its sole discretion, increase the number of directors, including to accommodate investors that invest subsequent to the initial closing of the offering of the Units, provided that the outside Investor appointing two directors pursuant to the paragraph above shall have the right to appoint additional directors as required to maintain a ratio of such Investor's designees to total Board members of not less than 2/15ths. "Independent Directors" of the Board of Directors of the General Partner shall be individuals who (a) are not (i) a Principal, (ii) a family member of a Principal, (iii) an employee of a Principal or any entity controlled by one or more of the Principals, and (b) meet the definition of "independent director" set forth in Rule 303A.02 of the New York Stock Exchange Listed Company Manual (as if the General Partner, the Partnership and each of its Subsidiaries were the "listed company") , including any such individuals appointed by the Investors who otherwise satisfy the requirements of this definition. At the time of the final closing of this offering, the General Partner will have at least two Independent Directors. After the Initial Listing and so long as consistent with contractual, listing and licensing obligations, a majority of the board of directors of the listed company will be Independent Directors.
Initial Listing Process:	"Initial Listing" means a listing on a recognized international securities exchange with a substantially concurrent underwritten offering generating gross proceeds of U.S. $200 million or more. "Initial Listing" refers to the Initial Listing of KUE or any successor or any subsidiary of KUE to which substantially all of KUE's assets and liabilities have been transferred or are held. The General Partner may take and cause KUE to take such actions as the General Partner reasonably deems necessary to complete the Initial Listing on the recognized international securities exchange or exchanges selected by the General Partner, including without limitation a restructuring or reorganization or other transaction or asset transfer between or among KUE and any of its subsidiaries, and may require

Partners to exchange their interests in KUE and the General Partner for interests in a subsidiary of KUE.

Related Party Transactions:

Related party transactions include transactions between (1) any of the Principals or any of their affiliates or any entity controlled by any of the Principals, and (2) KUE or any direct or indirect subsidiary or joint venture of KUE involving more than $1 million (including, for the avoidance of doubt, any merger, acquisition, asset purchase or similar transaction between KUE, its subsidiaries or joint ventures, on the one hand, and any person of which fifteen percent (15%) or more of the voting stock (or similar voting interests) is owned by KUE LLC or its affiliates, on the other hand). Related party transactions do not include (a) any transaction solely between or among KUE and any of its direct or indirect subsidiaries or joint ventures in which the Principals do not have any direct or indirect ownership interest (other than as a result of their ownership in the General Partner and KUE), (b) reasonable and customary director, advisory board member, or consultant compensation and benefits (including, without limitation, retirement, health, stock option and other benefit plans) as approved by the Independent Committee, provided that any such compensation, benefits and arrangements to the Principals that do not exceed $1 million in the aggregate annually shall not be subject to such approval, and customary indemnification arrangements, (c) transactions and arrangements pursuant to or contemplated by express terms of the Limited Partnership Agreement of KUE, including the "Investment in Subsidiaries" and "Co-Invest Right" described below, and any payments pursuant thereto, and the Fixed Overhead Payment described above, (d) agreements, transactions and arrangements described in “Related Party Transactions” in this Private Placement Memorandum and any amendment thereto (so long as such amendment is not disadvantageous to the Investors as a whole in any material respect) or any transaction contemplated thereby and any payments pursuant thereto, and (e) admissions of any affiliate of the Principals to KUE as a Limited Partner on terms substantially equivalent to concurrent admissions of persons that are not affiliates of the Principals.

If the size of the related party transaction is greater than $1 million and equal to or less than $50 million, then either (a) the Independent Committee must approve the transaction or (b) the transaction must be approved by the holders of a majority of the Common LP Units unaffiliated with the Principals.

If the size of the related party transaction is greater than $50 million, then the transaction must be approved by both (a) the Independent Committee and (b) the holders of a majority of the Common LP Units unaffiliated with the Principals.

Investment in Subsidiaries:	Not in limitation of any commitments or restrictions the Principals may have entered into, prior to an Initial Listing, KUE may not permit any of its subsidiaries or controlled joint ventures (which shall not include, for the avoidance of doubt, certain exempt companies contemplated by the following paragraph) to issue or grant any equity interests in such subsidiaries or controlled joint ventures to any of the Principals or any of their affiliates (other than KUE, its subsidiaries and controlled joint ventures) unless (i) the Independent Committee approves and the Investors who are accredited investors (as such term is defined in Regulation D) or otherwise legally eligible to participate are offered the opportunity to participate on the same terms as the Principals and their affiliates and in proportion to their economic ownership of KUE or (ii) such subsidiary or joint venture of KUE has completed an initial listing on a recognized international securities exchange, subject to certain limited exceptions. The Principals intend that KUE will be their exclusive vehicle for equity investment opportunities in and acquisitions of for-profit companies engaged primarily in the business of pre-K through 12th grade education of children, subject to limited exceptions as set forth in "The Structure of KUE and the General Partner" in this Private Placement Memorandum.
Transferability of Units:	The Common LP Units and the Class A Shares comprising the Units owned by the Investors will not be separately transferable, and the Units are to be transferred as a whole unless otherwise approved by the Board of Directors of the General Partner and the Independent Committee (defined below). Units held by an Investor may not be sold, transferred or assigned without the prior written consent of the General Partner, not to be unreasonably withheld. The General Partner intends, during the first two years after the applicable closing of the offering, to approve transfers of the Units to an affiliate of the Investor, in compliance with applicable law. After such time, the General Partner intends to approve transfers of Units to an affiliate of the Investor or to another Investor (and affiliates thereof), in each case in compliance with applicable law. The General Partner also intends to approve transfers pursuant to the Tag-Along Right and Drag-Along Right provisions described below.
Tag-Along Right:	Unless the Investors' Units (or securities received in exchange for Units if the Initial Listing is of a Subsidiary of KUE) are freely tradable without volume restrictions on the exchange on which the Initial Listing occurred, with respect to any proposed transfer of the Common LP Units held by KUE LLC and its affiliates to a non-affiliate purchaser (and, unless otherwise approved by the Board of Directors and the Independent Committee of the General Partner, a

	corresponding percentage of Class A Shares held by KUE LLC), the Investors may sell a pro rata portion of their Common LP Units and corresponding Class A Shares in the proposed transfer on the same terms and in exchange for the same consideration per Unit (and Class A Share) received by KUE LLC and its affiliates. Following the Initial Listing, the tag-along right will continue for certain Investors with respect to transfers for value of the Units (or units of the listed entity as the case may be) by the Principals or their affiliates to non-affiliates (excluding transfers on a recognized international securities exchange) above the following thresholds in one or more transactions: (i) 15% of the Principals' original KUE holdings to any single buyer (or affiliates of that buyer) or (ii) 33% of the Principals' original KUE holdings in the aggregate.
Drag-Along Right:	Prior to the Initial Listing, with respect to any proposed transfer of a majority of the Units held by KUE LLC to a proposed non-affiliate purchaser (and, unless otherwise approved by the Board of Directors and the Independent Committee of the General Partner, a corresponding percentage of Class A Shares held by KUE LLC), the Investors may be required to sell a pro rata portion of their Units and corresponding Class A Shares in the proposed transfer on the same terms and in exchange for the same consideration received by KUE LLC.
Co-Invest Right:	Prior to the Initial Listing, if KUE proposes to issue for cash any Units or securities convertible into Units after the Offering Period (subject to certain exceptions), then KUE is required to offer to each Investor that is an accredited investor (as such term is defined in Regulation D) or otherwise legally eligible to participate in the offering, the right to purchase a pro rata portion of such securities. Prior to the Initial Listing, the Investors have substantially equivalent rights with respect to issuances of securities by the General Partner.
Additional Listing of Investors' Units:	Beginning any time after six months after the Initial Listing, one or more holders holding an aggregate of $100 million of more of the Units may request KUE and the General Partner to take such action as may be necessary for their Units to be freely tradable and not subject to volume restrictions on the international securities exchange on which the Initial Listing occurred; provided that no more than one such action may be required in any 12 month period and customary cut-back and other provisions will apply in any such listing or underwritten transaction, as the case may be. KUE will use its commercially reasonable efforts to cause such action to cover such holders and the securities of any other holders legally eligible to participate in such action.

Term:	The term of KUE will be indefinite, unless terminated earlier in accordance with the Limited Partnership Agreement.
Illiquidity Period:	KUE will operate for a period of seven years from the date of the first closing of this offering. If there has not been an Initial Listing by the end of seven years from the date of the first closing of this offering, the Board of Directors of the General Partner will determine whether to pursue a sale of KUE or an Initial Listing (or a dual track process); provided, however, in the event that not less than 75% of the value of KUE at that time is represented by shares of securities listed on one or more recognized international securities exchanges and such shares have been or will be distributed as soon as reasonably practicable thereafter to the Investors and the Investors have received distributions of cash and/or such securities valued at amounts equal to or in excess of their original capital contributions, then there shall be two extensions of one year's duration each in order for KUE to complete either an Initial Listing or to have the remaining value of KUE represented by shares of securities listed on a recognized international securities exchange and to distribute such shares to the Investors. The Board of Directors shall approve the desired course of action. If the Board determines to pursue a sale of KUE (or an Initial Listing or a dual track process), then the Principals must determine at such time whether they intend to participate as a potential bidder in the sale process. If the Principals elect not to participate as a potential bidder in a sale process, then they will not be allowed to subsequently elect to participate as a potential bidder unless the sale process does not result in a buyer at a price the Independent Committee deems to be "fair." If the sale process results in a transaction that the Independent Committee deems to be "fair", the Principals will be required to sell their entire stake in KUE (Common LP Units and Profits Participation LP Units on an "as converted" basis) on the same terms as the Investors. If the Principals elect to participate as a potential bidder in a sale process, then the sale process will be managed by the Independent Committee and the Principals will be precluded from participating in Board deliberations regarding the sale process. In addition, the Principals will be required to sell their entire stake in KUE on the same terms as the Investors to the winning bidder in the event the Principals do not submit the most attractive bid. In the event that a sale of KUE or an Initial Listing has not occurred within nine years from the date the first Investors are admitted to KUE, the Independent Committee shall determine whether to pursue a sale of KUE (or an Initial Listing or a dual track process). A majority vote of the

	Independent Committee on this issue shall be binding on the Board of Directors of the General Partner and will require the Board of Directors of the General Partner to pursue such action within ninety (90) days.
Indemnification:	KUE will indemnify the General Partner and its members, officers, directors, and employees, and at the General Partner's discretion, any other person providing services to KUE, its subsidiaries or joint ventures. KUE has provided a customary indemnity to the Agents in connection with their services.
Periodic Reporting:	KUE will provide annual audited financial statements and semi-annual reports. The General Partner will provide such periodic reports if engaged in any business other than acting as general partner of KUE or if it owns any material assets other than an interest in KUE.
Certain U.S. Federal Income Tax Consequences:	For a discussion of certain U.S. federal income tax consequences that may be relevant to prospective investors, please read "Certain Income Tax Consequences" in this Private Placement Memorandum.

3. USE OF PROCEEDS

The proceeds of this offering will be used: (i) to expand operations, including through strategic acquisitions in the U.S. and internationally, (ii) to develop new products and services, (iii) to repay, in whole or in part, $150 million of existing debt plus accrued interest (including through application of a portion of the proceeds of the initial closing of the offering after payment of expenses and preferred returns), which currently bears interest at either the reserve adjusted LIBOR rate plus 0.125% or the base rate (generally the applicable prime lending rate, as announced from time to time), (iv) to pay an estimated $50 million in fees and expenses (including amounts payable to the Agents and including amounts payable from July 1, 2006 under the Fixed Overhead Payment Agreement), (v) in the discretion of KUE LLC, payment at the initial closing of the offering of approximately $7.0 million of accrued return on the preferred limited partner units of KUE being converted to Common LP Units if such accrued return is not converted to Common LP Units and (vi) for other corporate purposes. Until the proceeds are used, KUE currently intends to invest the unapplied proceeds in cash-equivalents and short-term marketable securities.

4. CAPITALIZATION

The following table sets forth KUE's cash, cash equivalents and senior capitalization as of December 31, 2005:

- on an actual basis; and
- on a pro forma basis to give effect to the sale of $1 billion in Units in this offering by KUE after deducting estimated offering fees and estimated offering expenses payable by KUE.

You should read this table together with "Management's Discussion and Analysis of KLC's Pro Forma Results of Operations" and the audited and unaudited consolidated financial statements and the related notes appearing elsewhere in this Memorandum. See "Related Party Transactions" for more information on related party interests.

KUE Senior Capitalization

	As of April 1, 2006		
	Actual	**Adjustments[1]**	**Pro Forma**
Cash			
KUE	$9.4	$800.0	$809.4
KUE Inc.	5.4		5.4
KSI	3.0		3.0
KLC OpCo	115.4		115.4
KLC PropCo	31.8		31.8
Total Cash	$164.9	$800.0	$964.9
Debt			
KUE[2]	$150.0	($150.0)	$0.0
KUE Inc.[3]	183.9		183.9
KLC OpCo – Sr. Sub. Notes	260.0		260.0
KLC OpCo - Capital Leases	16.2		16.2
KLC PropCo - CMBS	697.7		697.7
KLC PropCo - Junior Mezzanine[4]	147.9		147.9
Total Debt	$1,455.7		$1,305.7
Preferred Equity			
KUE[5]	180.0	(180.0)	0.0
Total Debt and Preferred Equity	$1,635.7		$1,305.7

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[1] *Assumes $50 million of fees and expenses.*

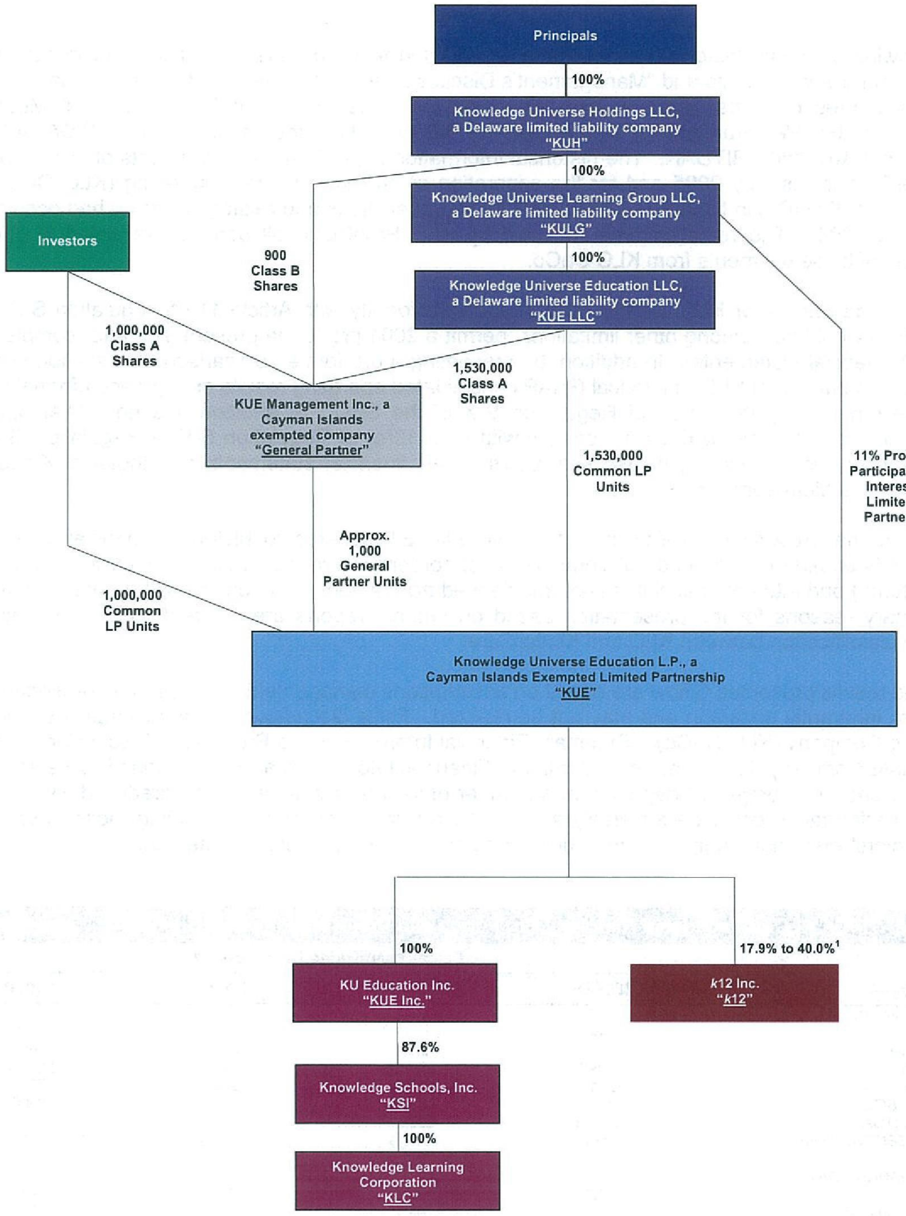
[2] *Upon closing, KUE LLC will contribute all of its assets to KUE. In addition, upon contribution of assets to KUE by KUE LLC, KUE will become a co-borrower to the KUE LLC term loan which will be repaid with the proceeds of the offering.*

[3] *Includes capitalized interest of $10.7 million.*

[4] *Represents book value net of original issue discount plus capitalized interest. Original principal amount is $150 million.*

[5] *Reflects the conversion of existing preferred limited partner units of KUE LLC into common limited partner units of KUE at the offering price.*

Organizational Structure – Pro Forma for Funding of $1 Billion. All figures are rounded.


Principals
100%
Knowledge Universe Holdings LLC, a Delaware limited liability company "KUH"
100%
Knowledge Universe Learning Group LLC, a Delaware limited liability company "KULG"
100%
Knowledge Universe Education LLC, a Delaware limited liability company "KUE LLC"
Investors
900 Class B Shares
1,000,000 Class A Shares
1,530,000 Class A Shares
KUE Management Inc., a Cayman Islands exempted company "General Partner"
1,530,000 Common LP Units
11% Profits Participation Interest Limited Partner²
Approx. 1,000 General Partner Units
1,000,000 Common LP Units
Knowledge Universe Education L.P., a Cayman Islands Exempted Limited Partnership "KUE"
100%
17.9% to 40.0%¹
KU Education Inc. "KUE Inc."
k12 Inc. "k12"
87.6%
Knowledge Schools, Inc. "KSI"
100%
Knowledge Learning Corporation "KLC"

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[1] *KUE owns preferred stock that is convertible into 17.9% of k12's Common Stock. KUE's ownership varies depending on the liquidation value or sale value of k12 and according to the preference of the various securities KUE owns. At higher valuations, KUE's percentage ownership is lower. See "k12 Inc. (k12) – k12 Equity."*

[2] *Of those Profits Participation LP Units outstanding immediately after the offering, 2/11ths will be allocated or held for the benefit of persons other than the Principals or their affiliates.*

5. SUMMARY FINANCIAL DATA

The following summary historical pro forma and projected financial data should be read in conjunction with the financial statements and "Management's Discussion and Analysis of KLC's Pro Forma Results of Operations" presented elsewhere in this Memorandum. See also "Non-GAAP Financial Measures" elsewhere in this Memorandum for a discussion of the derivation and limitations of EBITDA, Adjusted EBITDA and Adjusted EBITDAR. The historical information is pro forma for the effects of our acquisition of KinderCare in January 2005 and for the separation of our business into operating (KLC OpCo) and property (KLC PropCo) in November 2005, as if those transactions and related financing had occurred on January 1, 2004. The rental income received by KLC PropCo in all periods presented is primarily comprised of lease payments from KLC OpCo.

Our pro forma results for KLC were not prepared in conformity with Article 11 of Regulation S-X of the SEC (which would not, among other limitations, permit a 2004 pro forma presentation after completion of our 2005 financial statements). In addition, by presenting a pro forma comparison, this section does not include a comparison of KLC's historical GAAP consolidated operating results or segment information that would be required by Item 3-03 of Regulation S-X of the SEC. In addition, the non-GAAP financial information presented below does not comply with Item 10(e) of Regulation S-K or Regulation G of the SEC. For further information, please see KLC's GAAP financial statements and those of KinderCare included in this Memorandum.

The pro forma presentation below is not shown with adjustments to historical financial statements. Instead, it is based on a "ground up" combination of corporate level expenditures (overhead and capital expenditures) and internal financial statements derived from a center-by-center build up of KLC's results. The primary reasons for the presentation based on internal reports are different fiscal year ends and expense classification between KLC and KinderCare.

Projected results presented below are based on assumptions management believes to be reasonable, but which are inherently uncertain and may not be realized. For a discussion of the assumptions, see "The Operating Company (KLC OpCo) – Summary Financial Information and Projections Discussion" and "The Real Estate Company (KLC PropCo) – Summary Financial Information and Projections Discussion." Our ability to perform as projected depends on a number of variables that cannot be predicted with certainty and our performance could be adversely affected by a number of factors, including those described in "Risk Factors" elsewhere in this Memorandum. See also "Forward-Looking Statements."

KLC Consolidated Historical Pro Forma and Projected Financial Summary

	Fiscal Year Ended December 31,			
($ in millions)	**2004PF[1]**	**2005PF[1]**	**2006P**	**2007P**
OPERATIONAL DATA:				
Revenue	$1,442.2	$1,477.7	$1,557.8	$1,661.0
Revenue Growth		*2.5%*	*5.4%*	*6.6%*
Gross Profit	$329.6	$340.7	$387.0	$421.4
Adjusted EBITDA[2]	$231.4	$238.0	$249.7	$272.6
Adjusted EBITDA Margin	*16.0%*	*16.1%*	*16.0%*	*16.4%*
Adjusted EBITDAR	$344.5	$359.1	$363.1	$387.7
Adjusted EBITDAR Margin	*23.9%*	*24.3%*	*23.3%*	*23.3%*
OTHER FINANCIAL DATA:				
Interest Expense	89.9	89.9	89.9	89.5
Capital Expenditures	70.6	83.1	69.9	60.2

KLC OpCo Historical Pro Forma and Projected Financial Summary

($ in millions, except for weekly tuition)	Fiscal Year Ended December 31,			
	2004PF[1]	2005PF[1]	2006P	2007P
OPERATIONAL DATA:				
Revenue	$1,442.2	$1,477.7	$1,557.8	$1,656.5
Revenue Growth		*2.5%*	*5.4%*	*6.3%*
Gross Profit	$233.3	$244.4	$290.7	$320.6
Adjusted EBITDA[2]	$143.3	$149.9	$161.7	$179.9
Adjusted EBITDA Margin	*9.9%*	*10.1%*	*10.4%*	*10.9%*
Adjusted EBITDAR	$352.8	$367.4	$371.4	$391.4
Adjusted EBITDAR Margin	*24.5%*	*24.9%*	*23.8%*	*23.6%*
OTHER FINANCIAL DATA:				
Interest Expense	$23.5	$23.5	$23.6	$23.5
Capital Expenditures	70.6	83.1	69.9	60.2
# of Centers	2,021	1,934	1,894	1,878
Average Weekly Tuition	$156.61	$167.35	$173.68	$179.99
Utilization	*61.6%*	*61.2%*	*62.2%*	*63.0%*

KLC PropCo Historical Pro Forma and Projected Financial Summary

($ in millions)	Fiscal Year Ended December 31,			
	2004PF[1]	2005PF[1]	2006P	2007P
OPERATIONAL DATA:[3]				
Rental Revenue From KLC OpCo	$96.3	$96.3	$96.3	$96.3
Other Rental Revenue	0.0	0.0	0.0	4.6
Total Revenue	$96.3	$96.3	$96.3	$100.9
Operating Expenses	$8.3	$8.3	$8.3	$8.3
EBITDA	$88.1	$88.1	$88.1	$92.6
OTHER FINANCIAL DATA:				
Interest Expense	$66.4	$66.4	$66.3	$66.0

k12 Historical and Projected Financial Summary

($ in millions)	Fiscal Year Ended June 30,			
	2004	2005	2006P	2007P
OPERATIONAL DATA:				
Revenue[4]	$71.4	$85.3	$116.0	$132.2
Revenue Growth		*19.5%*	*36.0%*	*14.0%*
EBITDA	($1.9)	$2.2	$5.7	$12.3
EBITDA Margin	*(2.6)%*	*2.6%*	*4.9%*	*9.3%*
OTHER FINANCIAL DATA:				
Capital Expenditures	$4.3	$4.9	$9.4	$15.0
# of States Served[4]	11	11	12	14
# of Students	10,811	14,144	18,267	24,000

[1] *Pro forma for the effects of the acquisition of KinderCare in January 2005 and the separation of KLC into KLC OpCo and KLC PropCo in November 2005, as if those transactions and related financing had occurred on January 1, 2004.*

[2] *EBITDA and EBITDAR are adjusted for restructuring charges, closed center costs, (gains) / losses on center sales, (gains) / losses on minority investment, dividend income, IDS expenses, estimated parallel organization costs, management fees, KLC OpCo's long term incentive plan and Knowledge School Inc.'s SAR Plan-related costs allocated to KLC. See also "Management's Discussion and Analysis of KLC's Pro Forma Results of Operations" and "The Real Estate Company (KLC PropCo) – KLC PropCo Summary Financial Information and Projections Discussion."*

[3] *Does not include the reinvestment of real estate revenues. Please refer to "The Real Estate Company (KLC PropCo)" for this information.*

[4] *Includes only states in which virtual academies are operated. Includes Washington, D.C.*